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August 14, 2000

To: Members of the Executive Board

From: The Secretary

Subject: **Ecuador—Staff Report for the 2000 Article IV Consultation, Material for the First Review Under Stand-By Arrangement; and Exchange System**

Attached for consideration by the Executive Directors is the staff report for the 2000 Article IV consultation with Ecuador, which is tentatively scheduled for discussion on Monday, August 28, 2000. The report also contains material in connection with the first review under the Stand-By Arrangement for Ecuador. If all of the specified prior actions for the first review have not been met by the time of the scheduled Board meeting, the Article IV consultation will proceed as scheduled and the first review will take place once the prior actions are in place. A supplement containing additional information on performance with respect to the end-June quantitative performance criteria and progress on the prior actions will be issued prior to the Board meeting. Draft decisions appear on pages 39–41.

Mr. Goldsbrough (ext. 34735), Mr. Thornton (ext. 38683), Mr. Offerdal (ext. 38694), and Mr. Cortés (ext. 34172) are available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, August 22, 2000; and to the European Investment Bank and the Inter-American Development Bank, following its consideration by the Executive Board.

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Staff Report for the 2000 Article IV Consultation and Material for the First Review Under Stand-By Arrangement; and Exchange System

Prepared by the Western Hemisphere Department

(In consultation with the Fiscal Affairs, Legal, Monetary and Exchange Affairs, Policy Development and Review, Statistics, and Treasurer's Departments)

Approved by Claudio M. Loser and Jesús Seade

August 11, 2000

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EXECUTIVE SUMMARY

The major economic crisis that engulfed Ecuador in 1999 stemmed from: the failure to deal in a timely manner with emerging weaknesses in the banking system; policy weaknesses, including widening public sector deficits and an expansionary monetary policy geared to help contain the public sector's interest rate bill and support the fragile banking system; and a series of external shocks, including the El Niño weather phenomenon, the collapse in world oil prices, and the turbulent international financial situation. The effects of these factors were exacerbated by structural rigidities and political deadlock in the congress, which made it difficult to get the needed redirection of economic policies.

The economic program aims to restore confidence in economic management, stem the decline in economic activity, and lay the basis for economic recovery through: the dollarization of the economy; a substantial reduction in the combined fiscal deficit, consistent with a further improvement in the primary balance; significant structural reforms aimed at addressing the weaknesses in Ecuador's financial system, achieving a more flexible labor market, and facilitating the privatization of major state enterprises; and private sector involvement to secure additional external financing from debt relief and reduction.

Developments under the program have generally been as expected, or better: economic activity in the first half of 2000 has held up better than expected; the fiscal and external positions were stronger than programmed; the banking system was more liquid than anticipated; and the dollarization of the economy has proceeded rapidly. Policy initiatives also have been introduced, including: larger than programmed increases in domestic fuel prices in May accompanied by increases in spending on social programs and public sector wages; and measures to keep the banking strategy on track, including the introduction of a mainly voluntary scheme to restructure the large debts to banks of households and corporations. Foreign creditor relations have moved forward with the launch on July 27 of an offer by the authorities to exchange Brady bond and Eurobond debt for new unsecured "global bonds;" if successful, the exchange would result in a reduction in the face value of the stock of debt to bondholders of about 41 percent, and would be broadly consistent with restoring fiscal and external sustainability over the medium term.

The authorities also introduced some undesirable measures, including a reduction in the interest rate ceiling and restrictions on the fees that banks can charge for transactions. A liberalization, but not complete elimination, of the interest rate ceiling is foreseen in legislation sent to the congress in mid-July aimed at deepening further the process of structural reform.

On balance, the risks to achievement of the program's objectives—while still substantial—have diminished since Executive Board approval of the arrangement in April: there has been an improvement in cooperation with the Fund; the government has demonstrated political resolve with the implementation of the fuel price increases; the debt exchange will help make the short-run external position viable, and the long-run position more sustainable, provided a strong fiscal effort is maintained; and while the banking system remains fragile, the likelihood of a major run on deposits appears to have diminished. However, there is no room for policy slippages on the difficult decisions needed to keep fiscal deficits low and to create a more robust financial sector—without which the hard-won gains of recent months will not be sustained.

I. Introduction

1. A staff mission[1] visited Quito during June 12–30, 2000 to conduct the Article IV consultation discussions and the first review under the Stand-By Arrangement, which was approved on April 19, 2000 in the amount of SDR 226.73 million (75 percent of quota). On approving the arrangement, Directors noted that a broad national consensus would be needed to implement the policies envisaged under the program. They stressed that dollarization would need the support of strengthened public finances, greater labor market flexibility, and policies to strengthen the banking system, including: the development of a liquidity recycling facility and a liquidity support fund; improved bank supervision and prudential regulation; a stronger deposit insurance agency; and the development of a voluntary framework for restructuring the large debts to banks of households and corporations. Directors also called for the early removal of the caps on interest rates, which were seen as inconsistent with the dollarization framework and the goal of strengthening the banking system.

2. Directors felt that the degree of wage restraint and the increase in domestic fuel prices envisaged in the program were likely to prove controversial and difficult to implement. They were also concerned about the low level of budgeted social spending and urged that this be increased at the earliest opportunity. Given the large financing needs of the program, and Ecuador's poor prospects for regaining market access in the near future, Directors stressed the need for private sector involvement in financing the program, including through cash flow relief and debt reduction. To this end, Directors urged the authorities to make every effort to reach an early cooperative solution with private sector creditors to secure the needed financing.

3. Cooperation with the Fund has improved since President Noboa assumed office on January 22. However, the government's room for maneuver remains limited by a divided congress, in which the government's party controls only a minority of the seats, and where the coalition supporting the reform agenda is narrow and divided on many issues.

4. The discussions took place prior to the authorities' offer of an exchange of new uncollateralized "global bonds" for Brady bond and Eurobond debt, which was launched on July 27, 2000, and was scheduled to close on August 23, 2000 (Box 1). The staff had emphasized to the authorities the need for the terms of the offer to address Ecuador's longer-term debt sustainability problem. Staff examined the terms of the exchange and found them broadly consistent with achieving fiscal and external sustainability over the medium term.[2]

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[1] The mission team comprised Mr. Thornton (Head), Messrs. Offerdal and Cortés, Ms. Zermeño (all WHD), and Messrs. Delgado (MAE) and Ramirez (PDR). The mission was assisted by Mr. Franks, the Fund resident representative in Quito.

[2] The implications of a successful debt exchange on fiscal and external sustainability are assessed in Section H and Appendix II.

Box 1. The Debt Exchange Offer

The debt exchange offer was launched on July 27, with the exchange to take place on August 23. It includes a provision that bondholders who have accepted the offer may withdraw by August 16 if at that time Ecuador is not able to state that it has received confirmation that IMF management is prepared to recommend to the Executive Board that the first review of the program be completed. The minimum take-up for the offer to be effective is 85 percent. The offer is a swap of all Brady bonds and Eurobonds (combined face value of US$6.5 billion) into a single 30-year "global bond" (see table below). The exchange ratios are linked to the historical stripped secondary market relative prices of the different type of bonds. The global bond pays a step-up coupon starting at 4 percent, increasing by 1 percent annually to a maximum of 10 percent in 2006. In addition, bondholders have the option of converting their 30-year bonds into a 12-year bond, with a fixed coupon of 12 percent, in return for additional debt reduction (an exchange ratio of 0.65:1 on the 30-year-bond). Because the 12-year bond imposes a bigger cash flow burden in the short to medium term, the amount issued is capped (at US$1.25 billion). The government is committed to retire 3 percent of the face value of the 30-year bond in each year from 2013 until maturity, and US$125 million in face value of the 12-year bond annually starting in 2006, the remaining principal of both bonds being amortized through a final bullet payment. Existing arrears will be cleared in cash and through the release of the interest collateral (US$186 million). The first coupon payments on the new bonds will not be due until the first half of 2001, and total cash payments to bondholders in 2000 are estimated at US$140 million. A 100 percent take-up of the exchange offer would result in a reduction in the stock of Brady and Eurobond debt of about 41 percent (assuming, as expected, there is a 100 percent take-up of the 12-year bond). Debt service falling due during the first five years would be reduced by US$1.5 billion.

Ecuador: The Debt Exchange
(In millions of U.S. dollars)

	Pre-exchange debt stock	Exchange factor	Post-exchange debt stock 1/ (global bonds)
Brady bonds	5,961		
Of which			
PDI	2,728	0.78	2,128
Discount	1,435	0.58	832
Par	1,655	0.40	662
Interest equalization (IE)	143	1.00	143
Eurobonds	500	1.00	500
Total debt	**6,461**		**4,265 2/**

1/ Assumes 100 percent take up of 30-year global bond and includes US$112 million in new debt issued to pay accrued interest on existing bonds.

2/ Debt stock falls to US$3,874 million assuming 100 percent take-up of the 12-year bond.

5. As the first review under the Stand-By Arrangement was delayed due to ministerial changes in the government, the authorities have requested that the schedule of purchases under the arrangement be rephased; that the third purchase, initially scheduled for end-August, be eliminated together with its corresponding review; and that the amount of this purchase be divided equally into the three remaining purchases (each of which remains subject to completion of a review). The proposed rescheduling of purchases is given in Table 2.

6. All the quantitative performance criteria of the program for end-April were met with the exception of that for non-interest domestic payments arrears (about US$39 million above program, mainly with respect to wages) (Table 3). The performance criterion for "excess" freely disposable international reserves of the central bank for end-June also was met and preliminary indications are that all other quantitative performance criteria were met, with the exception of the ceiling on arrears, for which a waiver may be needed. Preliminary indications are that the structural performance criteria for end-June also were observed, with the exception of that on cooking gas prices, for which the authorities request a waiver.[3] Three additional steps, all connected with legislation under the *Ley para la Promoción de la Inversión y la Participación Ciudadana (Ley Trole II)* are important for completion of the first review are: (i) passage by congress of the less restrictive interest rate ceiling (1.5 times the average lending rate) that has been proposed by the government (see paragraph 40); (ii) passage by congress of legislation under the *Ley Trole II* so that the financial transactions tax will only be replaced at the same time as a broader tax reform is implemented (see paragraph 33); and (iii) legislation permitting shareholders to retain ownership and control of a bank if its capital adequacy ratio falls below the regulatory minimum provided a capital strengthening program has been achieved (see paragraph 44). A supplement to the staff report reporting on the status of these measures and on performance with respect to performance criteria for end-June will be issued prior to the Board meeting. Because a political struggle in congress on the election of a new president of congress has delayed substantive discussion of the *Ley Trole II*, there is a significant probability that these prior actions will not have been completed by the scheduled date of the Board meeting. In that case, the staff would propose that the Board proceed with the Article IV consultation and complete the first review after the prior actions are in place.

[3] Discussions are still ongoing with respect to establishing a framework within which banks submit binding memoranda of understandings to the superintendent of banks in respect of obligations under agreed capital strengthening plans (item III.f in the matrix of financial sector reforms (see Appendix I). The supplement to be issued prior to the Board meeting will provide an update on the status of this performance criterion; a waiver may be required.

II. Background and Recent Developments

A. The Origins and Initial Effects of the Crisis

7. The major economic and financial crisis that engulfed Ecuador in 1999 had three main contributory factors:

- The failure to deal in a timely manner with emerging weaknesses in the banking system.

- Policy weaknesses, including widening public sector deficits and an expansionary monetary policy, geared to help contain the public sector's interest bill and support the fragile banking system. Substantial earmarking of tax revenues (about 65 percent of the total), and over-dependence of fiscal revenue on oil exports introduced rigidities into fiscal policy and contributed to the widening of fiscal deficits.

- A series of severe external shocks in 1998, including: the El Niño weather phenomenon in 1998, estimated by the Economic Commission for Latin America and the Caribbean to have caused economic damage of US$2.6 billion (13 percent of 1998 GDP); the collapse in world oil prices (Ecuador's average oil export price fell from US$15.5 a barrel in 1997 to US$9.2 a barrel in 1998), and the turbulent international financial situation.

8. The effects of these factors were exacerbated by longstanding structural rigidities in the economy (notably state monopolies in key economic sectors, and inflexible public sector pricing policies and labor markets) and political gridlock in the congress which made it difficult to get support for the needed redirection of economic policies.

9. The crisis followed several years of weak macroeconomic performance.[4] Real GDP growth averaged about 2½ percent a year during 1993–97 and stagnated in per capita terms; annual inflation in the same period averaged 31 percent; and social and poverty indicators generally deteriorated. In 1998–99, the economy plunged into a major economic and financial crisis: real GDP stagnated in 1998 and fell by about 7½ percent in 1999 (Figure 1); 12-month inflation in consumer prices accelerated to 102 percent in July 2000, and producer prices rose by over 300 percent; unemployment almost doubled to 17 percent; and there was a large increase in the number of people living in poverty and a widening of income inequality.[5]

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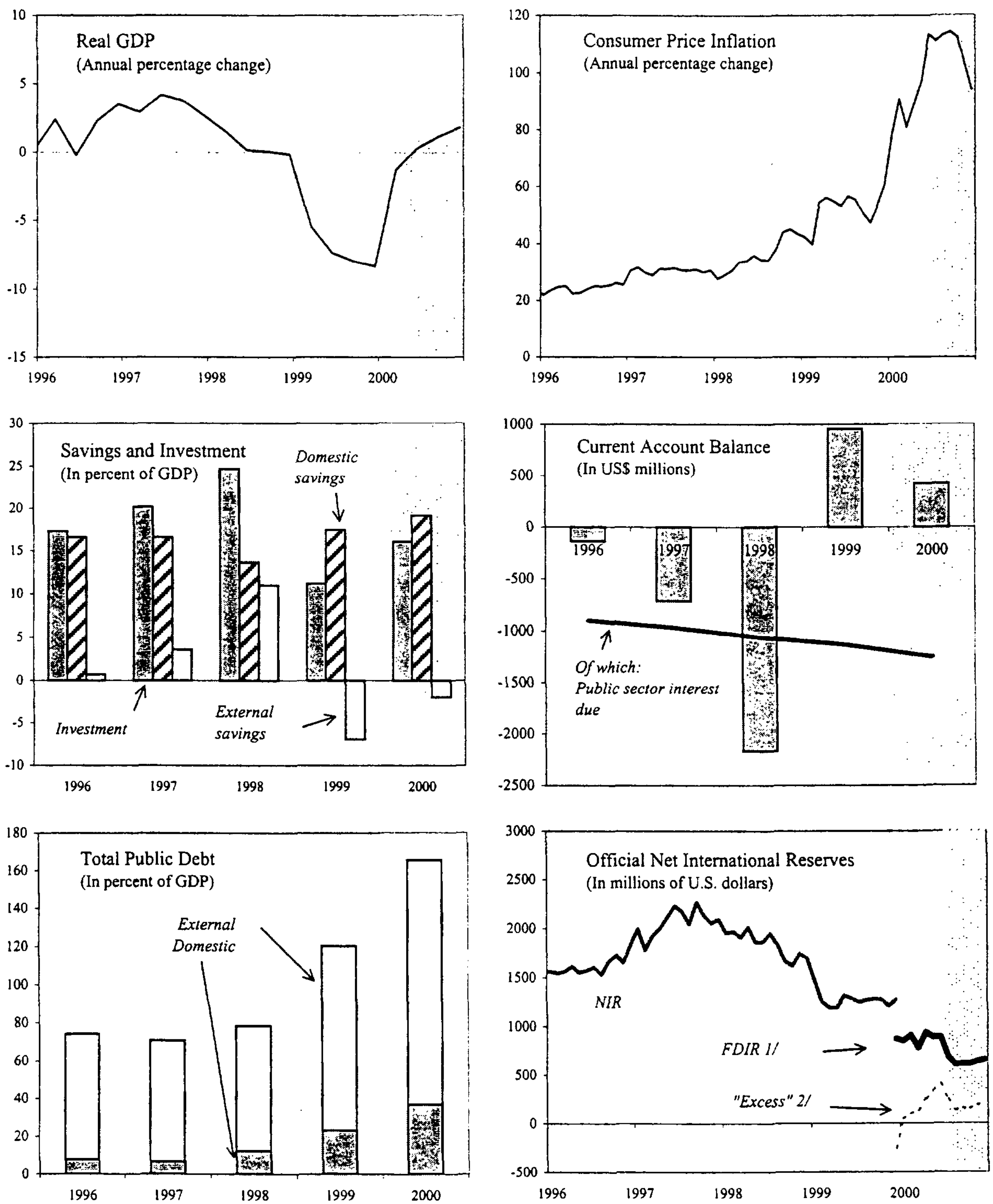
[4] The events leading up to the current crisis are discussed in more detail in: Ecuador—Request for Stand-By Arrangement; and Exchange System, EBS/00/66; and in the forthcoming background paper for the Article IV consultation.

[5] Recent developments with respect to income distribution are described in more detail in the background paper for the Article IV consultation.

Figure 1. Ecuador: Key Program Objectives



Sources: Ecuadoran authorities; and Fund staff estimates.

1/ Free disposable international reserves (FDIR), as defined in the "Ley Fundamental para la Transformación Económica del Ecuador."

2/ FDIR in excess of amount required by law to back central bank liabilities and net of use of Fund credit.

10. The deficit of the nonfinancial public sector (NFPS) widened from about 2½ percent of GDP a year in 1995–97, to around 6 percent of GDP in 1998–99 (Table 4). The primary balance shifted from a deficit of 1.2 percent of GDP in 1998 to a surplus of 4 percent in 1999, as oil revenues recovered sharply with the increase in world oil prices, and tax revenues increased by 1 percentage point of GDP mainly as a result of the increase in the import tariff surcharge, and the introduction of the financial transactions tax. Non-interest expenditures of the NFPS remained broadly unchanged in relation to GDP, but the interest bill jumped by about 5 percentage points of GDP (to 10 percent of GDP), reflecting the impact of the real depreciation of the *sucre*, and the interest cost of government bonds issued in connection with the banking crisis. Large losses on central bank operations pushed the combined fiscal deficit to 7 percent of GDP (from 5.9 percent of GDP in 1998).

11. The banking system has been in deep crisis since early 1998. The disruption to payments capacity caused by *El Niño*, and a reversal of capital flows associated with a worsening domestic environment and adverse developments in world financial markets, exacerbated vulnerabilities stemming from connected lending practices, and the growth of foreign currency credit to borrowers without earnings in foreign currency. Moreover, the failure to take timely action when serious difficulties emerged with specific banks early in 1998 laid the ground for a much broader crisis. The initial response reflected a combination of lax banking supervision and the absence of an adequate legal framework for the intervention of troubled banks. The introduction of the 1 percent financial transactions tax in January 1999 contributed to the problems by adding a disincentive to financial intermediation.

12. The government created a deposit insurance agency (AGD) in December 1998 with a mandate to restructure the banking system and announced a broad guarantee of deposits and external credit lines, including those held by offshore Ecuadoran banks. By this stage, however, doubts about the government's fiscal ability to sustain the guarantee led to a bank run, which forced the authorities to declare a bank holiday in March 8–12, 1999 and to freeze bank deposits.[6] Banks' nonperforming loans reached 40 percent of the total loan portfolio by end-1999 (up from 9 percent at end-1998),[7] and eventually sixteen financial institutions, accounting for about 65 percent of the system's onshore assets, were intervened or closed. In August 1999 the authorities began to unfreeze demand and savings deposits, with an estimated one-third of the freed deposits going into capital flight.

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[6] The freeze on bank deposits gave rise to an exchange restriction subject to Fund approval under Article VIII, Section 2(a), as it might have affected transfers of balances due in connection with current international transactions, including remittance of interest abroad on bank deposits held by nonresidents.

[7] Nonperforming loan ratios range from 15 percent in the case of private banks to 74 percent in the case of loan portfolios of closed banks being managed by the AGD.

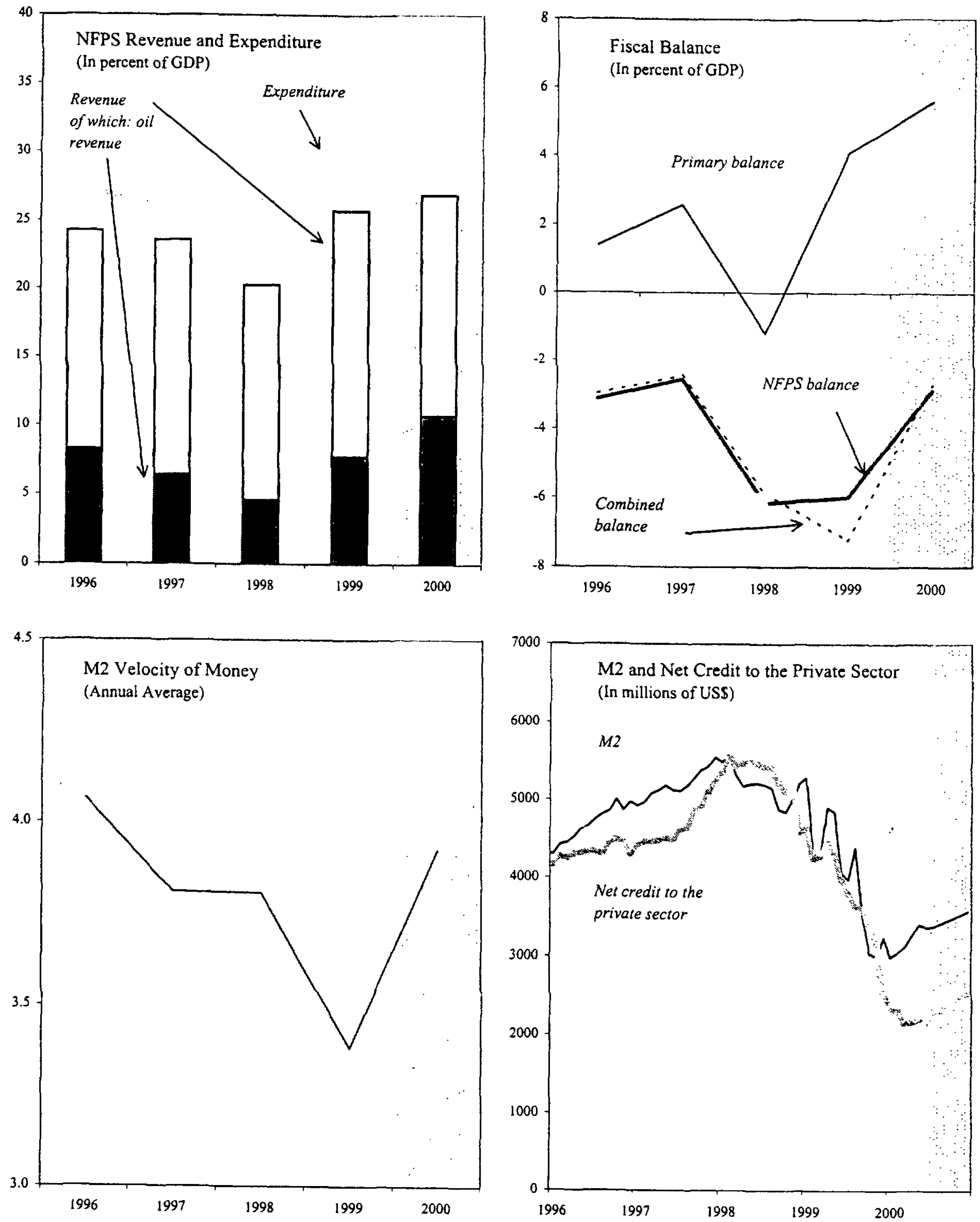
13. Monetary policy was undermined by the banking crisis. Almost all the US$1.4 billion of bonds issued to banks by the AGD in 1998–99 subsequently were rediscounted at, or sold to, the central bank as banks sought to replenish liquidity lost as a result of the run-down in credit lines, deposit flight, and the build-up on nonperforming loans. The flow of central bank credit to banks was equivalent to 5½ percent of GDP in 1998 and 7½ percent in 1999, and both currency issue and M1 rose sharply, in spite of sharp increases in domestic interest rates in 1998–99. Bank credit to the private sector slowed sharply in 1998 and fell by 27 percent in nominal terms in 1999 (Figure 2).

14. These monetary developments and a loss of confidence resulted in repeated episodes of exchange market pressures in the past two years. The *sucre* was devalued by 7 percent in March 1998 and by a further 15 percent in September 1998 (when the intervention band was widened); it was floated in February 1999 after heavy intervention and a doubling of interest rates (to around 180 percent) failed to stem the pressures (Figure 3). The freeze on bank deposits in March 1999 helped stabilize the *sucre* for several months, but it came under renewed pressure in November 1999 until the government announced in early January 2000 that it intended to dollarize the economy. In total, the *sucre* depreciated against the U.S. dollar by 54 percent during 1998 (December to December), 200 percent during 1999, and by a further 25 percent in the first week of January 2000. In real effective terms the exchange rate depreciated by about 47 percent from December 1997 to January 2000.

15. The external current account deficit widened to 11 percent of GDP in 1998 from 3½ percent of GDP in 1997, as both oil and nontraditional exports fell, and imports rose strongly. The deficit was financed mainly by short-term borrowing by commercial banks, the run-down of net international reserves, and an accumulation of external payments arrears. In 1999, private capital outflows of US$2.6 billion forced a drastic adjustment of the external current account balance to a surplus of 7 percent of GDP, with imports falling by 46 percent (in U.S. dollar terms). Exports fell modestly as weakness in nontraditional exports, reflecting the crisis in the corporate sector and weak demand in other Andean Community countries, more than offset the recovery in oil exports. Net international reserves fell by US$422 million during 1999 to US$1.3 billion.

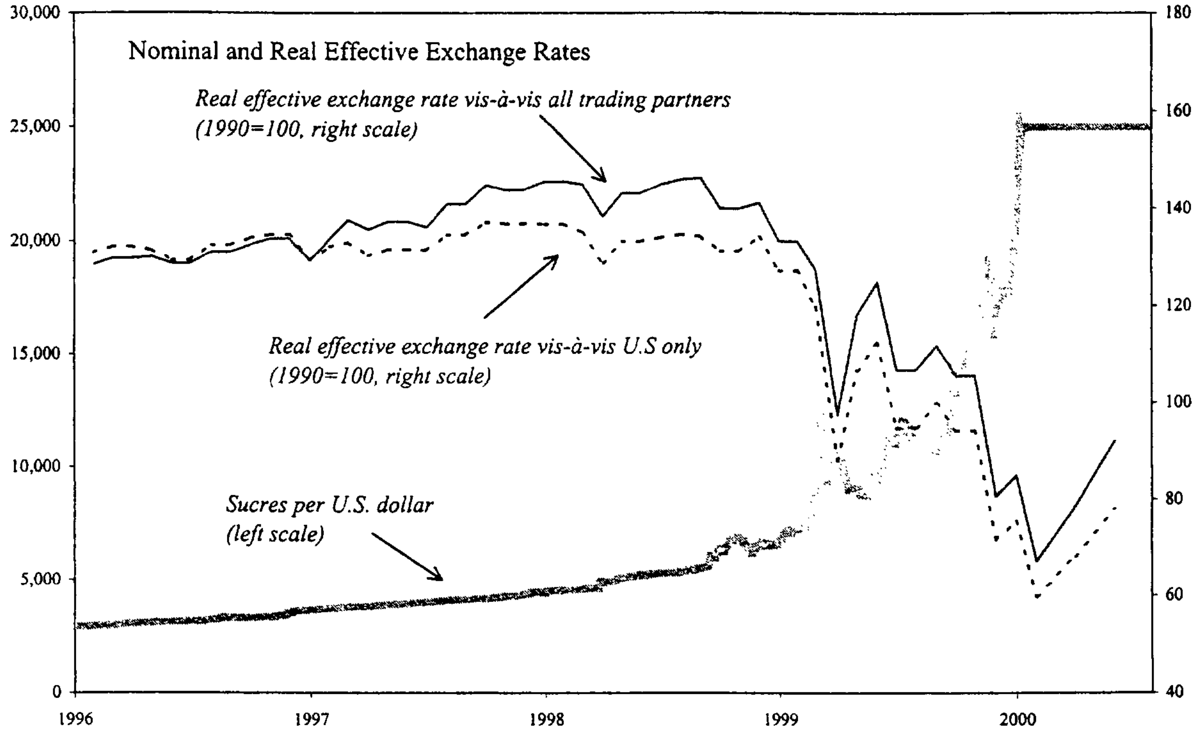
16. While Ecuador has been accumulating arrears to official bilateral creditors since 1996, it remained current on its Brady bond and Eurobond debt until September 1999. At that time, the government announced that it would meet the coupon payment on PDI bonds, but requested that bondholders release collateral to cover the parallel payment due on the Discount bonds. Although bondholders voted against this request, they did not resort to litigation. In October 1999, the government announced that it would default on the upcoming Eurobond coupon payment, and would restructure domestic public debt maturing between October 1999 and December 2000, resulting in about US$224 million of cash-flow relief in 2000. External payments arrears reached US$924 million at end-1999, of which three-quarters represented unpaid obligations to Paris Club creditors.

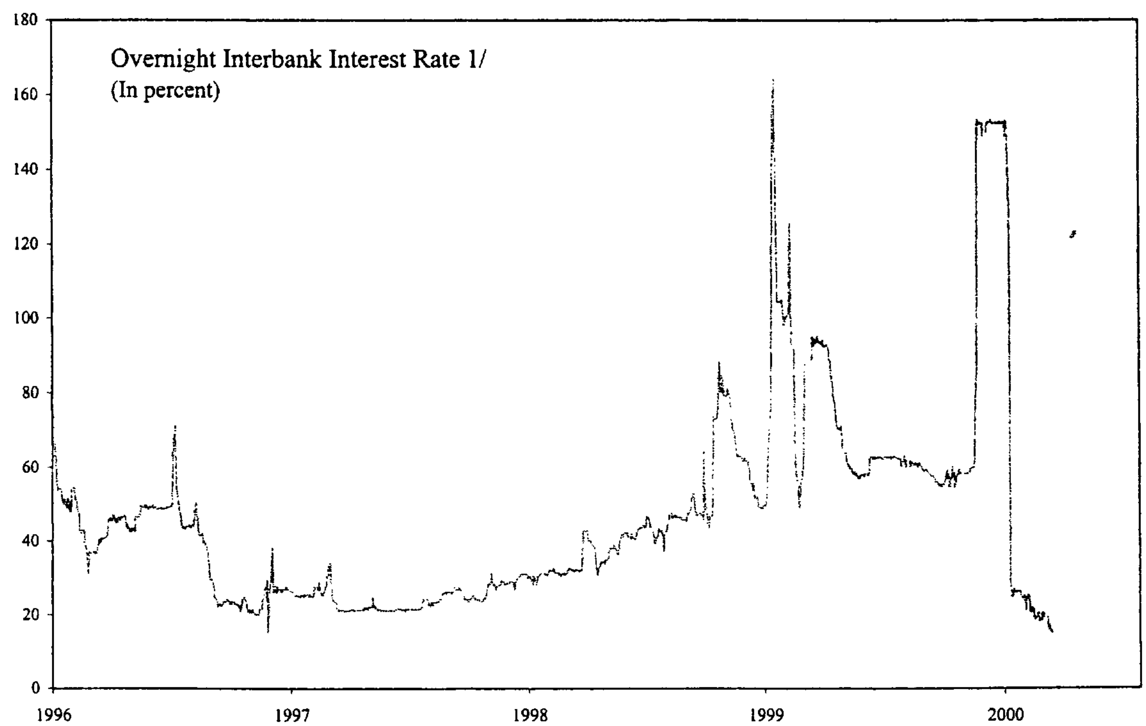
Figure 2. Ecuador: Fiscal and Monetary Developments



Sources: Ecuadoran authorities; and Fund staff estimates.

Figure 3. Ecuador: Exchange Rate and Interest Rate Developments





Source: Ecuadoran authorities; Information Notice System.

1/ The sucre interbank interest rate series ends in March 2000 due to dollarization.

B. Developments Under the Program

17. The government's economic program seeks to restore confidence in economic management, stem the decline in economic activity, and lay the basis for recovery in economic activity. The main elements of the program are: (i) the dollarization of the economy to eliminate the risks of monetary instability and future currency crisis; (ii) a sizeable fiscal adjustment to ensure that the remaining deficit could be financed; (iii) a strategy to restructure and strengthen the banking system, including through improved regulation and supervision, and restructuring the viable debts of households and companies; and (iv) structural reforms aimed at making the labor market more flexible, allowing more private sector participation in the oil sector, and the privatization of the electricity generation, distribution and transmission companies, and the two state telecommunications companies. The legal basis for many of the reforms, including the dollarization of the economy, is the *Ley Fundamental para la Transformación Económica del Ecuador* (known as *Trole I*) which was approved by the congress on March 9, 2000.

18. Economic activity in the first half of 2000 appears to have held up better than projected. In the first quarter of the year, real GDP increased by 0.8 percent from the previous quarter (falling by about 1½ percent year-on-year). Public and private investment continued to fall, but the decline in consumption appears to have bottomed out. Manufacturing sales, including motor vehicles, increased slightly in the first five months of the year; unemployment declined to 14 percent in June (from a peak of 17 percent last February); and business confidence indicators have improved. However, inflation is running at a much higher rate than projected, reflecting a post-dollarization real exchange rate path that is more appreciated than that assumed in the program (see Box 1), in part because recent increases in domestic fuel prices were larger that envisaged under the program (see below). Thus, in July, 12-month inflation in consumer prices reached 102 percent and in producer prices 205 percent in June, reflecting the large weight of petroleum products in the latter.

19. The fiscal position was stronger than expected, with the NFPS broadly in balance in the first four months of 2000, against an expected deficit of 2½ percent of GDP in the program. Revenues exceeded program estimates by the equivalent of 1.2 percentage points of GDP owing mainly to stronger oil prices (US$23 a barrel in the first half of the year compared to US$20 a barrel assumed in the program), more buoyant non-oil tax revenues, and improved tax administration.[8] [9] Expenditures were below program by 1.1 percentage point of GDP, reflecting shortfalls in investment spending.

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[8] On an annual basis, each US$1 per barrel increase in the oil price adds about US$50 million (0.4 percent of GDP) to fiscal revenues.

20. The banking system in the first half of 2000 was more liquid than anticipated. The unfreezing of US$1.2 billion of time deposits in open banks, which began on March 13, proceeded faster than expected as many banks converted to cash the bank bonds that were issued in lieu of frozen deposits. About US$200 million of frozen deposits were to be paid out in cash in March–July, but the deposit base of the banking system increased by about the same amount, suggesting that most of the time deposits unfrozen remained in the banking system. However, banks' external credit lines fell by a further US$40 million in June–July (to US$724 million), bringing the cumulative decline this year to about US$230 million. Credit to the private sector remains flat, and banks' nonperforming loan ratio reached 47 percent in June.

21. The dollarization of the economy has proceeded rapidly since congressional approval of *Trole I.*[10] By mid-July, *sucre* currency in circulation had fallen by two-thirds (or US$234 million), mainly reflecting currency exchange, and almost all *sucre*-denominated central bank bonds (US$356 million at end-1999) had been redeemed (Tables 6 and 7). Most salaries are now paid in U.S. dollars, store prices are largely U.S. dollar denominated, and bank accounts are exclusively denominated in U.S. dollars.

22. The external position is somewhat stronger than anticipated, reflecting a larger current account surplus because of stronger oil exports as well as a smaller than programmed liquidity out flow from the banking system. Although net free disposable international reserves fell by more than envisaged in the program, this reflected the rapid dollarization of the economy. Central bank "excess" freely disposable international reserves (i.e., above the amount needed for the required legal backing of central bank *sucre* liabilities) increased to US$256 million by end-April, US$90 million above the adjusted program target, and further to US$406 million by end-June, US$252 million above the program target (Table 3).[11]

23. Several policy initiatives also have been implemented since the Stand-By Arrangement was approved. On May 25, a package of fiscal revenue and expenditure measures was introduced which included: (i) increases in the prices of diesel and gasoline of 66–92 percent (i.e., beyond the increases the authorities committed to for July, but not as much as the cumulative July plus October increases in the program), and in other fuels of between 90–

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[9] Better tax administration has been associated, in part, with an improved tax-payer data base stemming from obligations under the financial transactions tax, and the introduction of strict invoicing requirements has helped in the control of VAT compliance.

[10] The background to dollarization and early developments are described in the background paper for the Article IV consultation.

[11] Target adjusted for lower than programmed multilateral disbursements and a small accumulation of external arrears.

333 percent (in most cases, higher than the cumulative increases committed to for July plus October); the price of cooking gas was kept unchanged; (ii) the elimination of the import tariff surcharge on electric appliances, parts and accessories, agricultural machinery, and second-hand engines; (iii) increases in public sector pay that averaged about 60 percent (in addition to a 10 percent public sector wage increase granted in April, the program had provided for further increases of 20 percent each in July and October); (iv) an increase in the monthly cash transfer to the poor (the *bono solidario*) of 75 percent (the program had provided for 50 percent); (v) increased spending on rural housing, pensions, child health and education programs, and infrastructure; and (vi) average increases in electricity tariffs of about 70 percent with monthly adjustments of 4 percent thereafter. The package as finally formulated by the authorities was successful in implementing a sizeable price adjustment without triggering major social disruptions.

24. Several steps were taken to keep the banking strategy on track. In June, the *Junta Bancaria* (Banking Board) approved resolutions that established: (i) a mainly voluntary scheme to restructure large viable debts of households and corporations, with incentives for creditor and debtor participation; (ii) a liquidity support fund for banks to be managed by the central bank; and (iii) loan classification and provisioning rules according to international standards. In addition: (i) "fit and proper" requirements and internal control procedures of banks were strengthened; (ii) a strengthening plan for the superintendency of banks was approved; and (iii) rules for access to the central bank's liquidity recycling facility were clarified to ensure the participation of banks whose capital adequacy ratio falls below the regulatory minimum provided they have an agreed capital strengthening program with the central bank.

25. However, some undesirable measures were also introduced. In April the central bank approved a preliminary interest rate ceiling for loans of 24 percent;[12] following political pressure, this subsequently was reduced to 20 percent by end-May. In addition, in early June the *Junta Bancaria* approved restrictions on the fees banks could charge for transactions, in particular a zero cap on fees charged in lieu of interest. While the interest rate cap and fee restrictions have had few implications for credit to large (mainly international) companies, who typically are paying 10–13 percent for bank loans, there are indications that they have restricted access to bank credit to traditionally higher risk borrowers, particularly the

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[12] The economic transformation law calls for the central bank to set a ceiling on domestic interest rates, calculated as the sum of LIBOR, plus an operating margin for the banks of up to 4 percent, plus a margin for country risk. In practice, because of the vaguely defined nature of these margins, this formula gives wide discretion to the central bank in setting the ceiling, which has left it open to political pressure. In addition, a regulation issued by the superintendency of banks calls for the provisioning for a temporary period (through April 2000) of corporate loan operations which carry interest rates in excess of 18 percent a year, and consumer loans with interest rates above 23 percent a year.

construction sector, small enterprises and consumers, and the maturity of credits extended has been shortened. As discussed below, liberalization of the interest cap is foreseen in legislation sent to congress in mid-July aimed at deepening further the process of structural reform.

26. Foreign creditor relations have moved forward, albeit more slowly than envisaged. In addition to the debt exchange launched in July (Box 2), negotiations to normalize relations with Paris Club creditors were initiated on May 18–19. The authorities requested exceptional treatment such that they would make no cash payments during the rest of 2000.[13] Creditors countered with a proposal that would have required cash payments of US$460 million during the program period (i.e., through end-March 2001), including the full payment of arrears and new maturities on the last Paris Club agreement and on post-cutoff date debt, and payment of *late interest and moratorium interest. However, creditors were prepared to negotiate further.* In light of the wide gap between creditor and debtor positions, the Paris Club chairman recommended to creditors a postponement of the discussions. The government has indicated that it intends to conclude the negotiations at a second meeting to be held in the week of September 10, 2000.

III. Report on Discussions

A. Overview

27. The discussions took place shortly after substantial changes in the authorities' economic team, following resignations of the Minister of Economy and Finance, the Undersecretary for the Budget, the President of the Central Bank of Ecuador, and several members of the central bank board. The new economic team expressed its commitment to the economic program supported by the Stand-By Arrangement.

28. To take account of developments in the first half of the year, the staff and the authorities agreed a slightly revised macroeconomic framework for 2000 in which real GDP growth was projected to be ½ percent (compared 0 to 1 percent originally); 12-month inflation would be somewhat higher at an average 101 percent and would end the year at 94 percent, although there would be a decline in monthly inflation to near single digit annual rates toward the end of the year; and the external current account surplus would be higher, mainly because oil exports were likely to perform better than projected (Box 3). The other elements of the macroeconomic framework, and the key targets of the program, remain unchanged.

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[13] The request included deferring to next year the clearance of arrears on post-cutoff date debt, rescheduling maturities on post-cutoff date debt, as well as arrears and maturities on pre-cutoff date debt on terms more generous than normally granted to similar countries.

**Box 2. Inflation, Interest Rate, and Real Exchange Paths
Following the Adoption of "Hard" Pegs**

During the last decade several countries adopted currency board arrangements (CBA) as their monetary system including Argentina (1991), Bulgaria (1997), Estonia (1992), and Lithuania (1994). The experience of these countries in terms of inflation and interest rate convergence to that prevailing in the country whose currency was adopted as an anchor, and the developments in their real exchange rate can provide some indication of how these key variables might evolve in Ecuador following dollarization.

- Those four countries introduced CBAs in the context of very high but declining inflation rates and, in the cases of Argentina and Bulgaria, following bouts of hyperinflation in the preceding two years. Convergence to the inflation rate of the countries whose currencies were used as anchor had not materialized after two years of the introduction of the currency board except for Bulgaria, although in each case inflation had fallen sharply (Figure 4).

- At the time of the introduction of the CBAs, prices for goods and services were mostly unregulated in these countries—administered prices had been largely liberalized in Estonia and Lithuania following independence, and there were frequent adjustments of the few remaining controlled prices in Argentina and Bulgaria. By contrast, Ecuador still is in the process of adjusting prices for goods and services set by the state (these prices have a direct impact on about 10 percent of the consumer price index, and mainly relate to energy and telecommunications) that were sharply reduced in U.S. dollar terms following the collapse of the *sucre* late last year and in early 2000. This suggests that inflation in Ecuador may not converge to U.S. rates for several years.

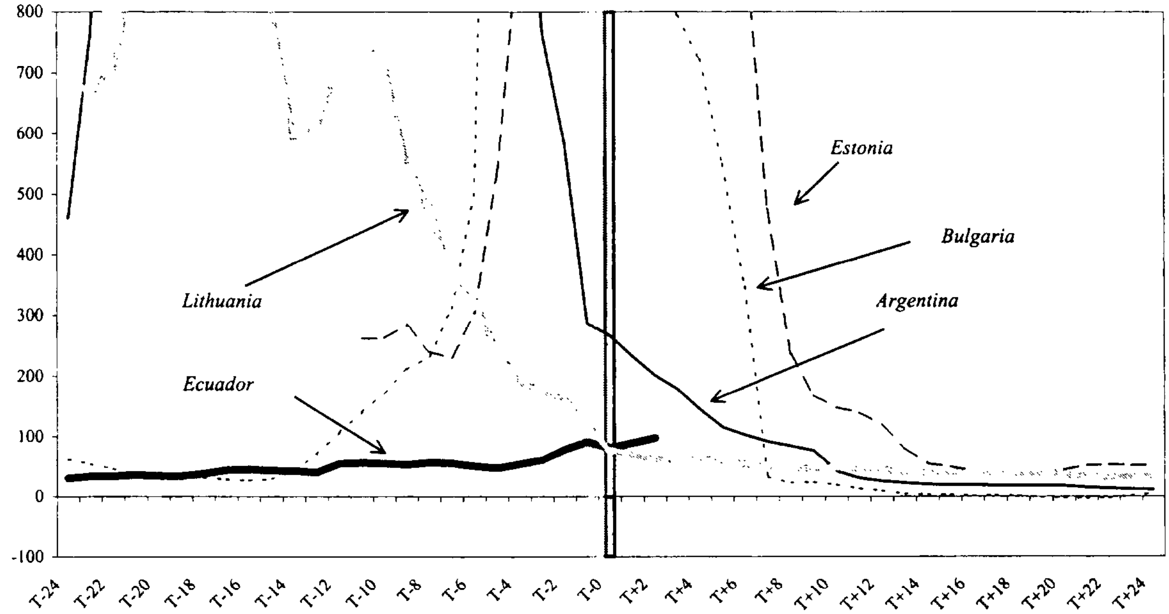
- In each of the four countries, the exchange rate started to appreciate in real effective terms a few months before the introduction of the CBA, a tendency that persisted afterward. By contrast in Ecuador, the exchange rate had a dramatic fall in real terms in the two previous years and up to the eve of the announcement of dollarization.

- In the countries which adopted CBAs, deposit and interbank interest rate spreads over the corresponding rates of the countries whose currencies were used as anchors narrowed very sharply in a short period of time, a development that already has started in Ecuador. By contrast, *lending rates converged less rapidly, and appear to have been influenced mainly* by conditions in the local banking system and domestic risk factors.

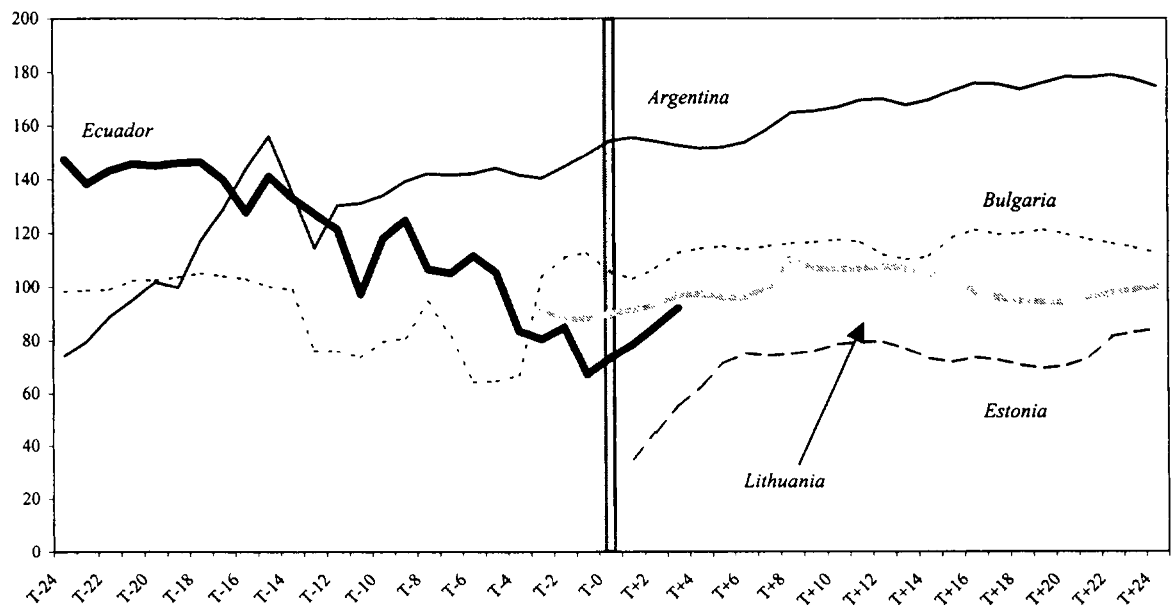
Ecuador's real effective exchange rate depreciated by about 48 percent from end-1997 to end-1999, and is projected to appreciate by 43 percent in the 12 months to December 2000. This would imply a real depreciation of about 5 percent between December 1997 and December 2000.

Figure 4. Ecuador and Selected Countries: Inflation and Real Exchange Rate Developments Before and After Introduction of Currency Board Arrangements 1/

Annual Consumer Price Inflation 2/
(In percent per year)



Real Effective Exchange Rate
(Indices, 1990=100)



Sources: Information Notice System and *International Financial Statistics.*

1/ On the horizontal axis, T-0 is the month the currency board arrangement was introduced, T-*n* the months preceding the currency board and T+*n* the months following the currency board.
2/ Inflation peaked at c. 20,000% in Argentina on T-13, at c. 2,000% in Bulgaria on T-4, at 1,200% in Estonia on T+2, and 1,400% in Lithuania on T-18.

Box 3. Revised Macroeconomic Framework, 2000

	HI	HII	Total
	(Annual percentage change)		
Real GDP			
Revised	-0.7	1.7	½
Original	-3.3 to -2.7	3.5 to 4.0	0 to 1
Consumer price inflation			
Revised: average	92	102	97½
end-of-period	106	87	87
Original: average	76	74	74
end-of-period	71	60	60
	(In millions of U.S. dollars)		
External current account balance			
Revised	830	-417	423
Original	788	-503	220
Change in net free disposable international reserves	410	49	459

B. Fiscal Policy

29. The discussions on fiscal policy focussed mainly on the implications of the May revenue and expenditure package; measures to safeguard fiscal revenues over the remaining period of the program, and the government's expenditure priorities for the rest of this year.

30. It was agreed that the combined fiscal deficit targets for 2000 would remain unchanged (in U.S. dollar terms) in 2000, although this issue will be revisited at the time of the second review. The program targets for the deficit of the NFPS and the quasi-fiscal surplus of the central bank have been adjusted to reflect an agreement between the ministry of finance and the central bank to reduce the interest rate (from 12 percent to 6 percent) on most of the central bank's portfolio of bonds issued by the AGD.[14] This agreement recognizes the much reduced role of the central bank after dollarization and the government's intention to provide the bank with an income base (interest from government bond holdings) sufficient to cover operating costs. In addition, the targeted fiscal adjustment in 2000 will be larger in relation to GDP because nominal GDP for 2000 has been revised upward mainly to reflect a

[14] The bonds initially were issued by the AGD to banks for recapitalization purposes; the banks later sold the bonds to the central bank.

more appreciated real exchange rate than assumed in the program (Box 4). Thus, the combined fiscal deficit will decline from 7.2 percent of GDP in 1999 to 2.7 percent of (revised) GDP in 2000, consistent with a reduction in the NFPS deficit over the period from 6 percent of GDP to 2.8 percent. In spite of the increases granted in May, public sector wages would still fall sharply in real terms this year, and by 0.8 percentage points of GDP (to 6.3 percent of GDP) from 1999 (Table 4).

Box 4. Revised Fiscal Targets, 2000

	(In millions of U.S. dollars)		(In percent of GDP)	
	Revised Targets	Original targets	Revised targets 1/	Original targets 2/
Combined fiscal deficit	355	355	2.7	3.2
NFPS deficit	374	431	2.8	3.9
NFPS primary balance	735	723	5.6	6.6
Central bank quasi-fiscal balance	19	75	0.1	0.7
Memorandum item:				
Wages and salaries	837	674	6.3	6.2

1/ In percent of revised GDP.
2/ In percent of original GDP.

31. In terms of expenditure priorities, the authorities' intention is to ensure that the adverse impact of the adjustment program on the most vulnerable groups is minimized. Efforts are underway to improve the targeting and efficiency of existing social programs; in the context of lending programs with the World Bank and the IDB, the authorities intend to develop an approach to poverty alleviation aimed at guaranteeing key basic social services that serve the poor—including primary and secondary education, primary health care and disease control—and sustaining cash transfers programs that complement the income of poor groups. The authorities intend to maintain spending on social programs this year broadly equal to the level of 1999 in real terms. They also intend to give priority to making up the shortfall in the public investment program recorded in the first four months of the year to provide support for economic activity and assist in poverty alleviation (priority is to be given to projects that are labor-intensive and/or provide access to vital services). No further increases in public sector

wages would be granted this year.[15] Within the program targets, the authorities also will seek to increase the payout on the deposit guarantee to small depositors.[16]

32. Energy consumption subsidies (estimated in relation to marginal cost and border prices) were reduced sharply as a result of the increase in domestic fuel prices in May (Box 5). The staff's assessment is that, compared with the program, the May measures could raise revenue by US$100 million, provided revenue from the increased price of fuel oil can be collected from the electric power companies which have been in arrears on such transfers.[17] The increases in electricity prices announced in May, and the planned monthly increases thereafter, should be sufficient to allow the companies to remain current on such payments and clear their outstanding arrears to the state oil company. The May package would raise expenditures by about US$130 million, mainly reflecting the increase in public sector wages; the small adverse impact on the fiscal deficit (about 0.2 percent of GDP) is more than offset by higher than programmed increases in other fiscal revenues.

33. Given the uncertainties regarding future oil price developments and available program financing, the authorities will take three measures to safeguard fiscal revenues for the remainder of this year: (i) further planned reductions in import tariffs, including the temporary import tariff surcharge, will be postponed until 2001 unless compensating revenue measures are introduced; (ii) plans to use certificates of frozen deposits in closed banks to pay taxes and import duties have been abandoned; and (iii) the elimination of the financial transactions tax, which was envisaged in the *Ley para la Promoción de la Inversión y la Participación Ciudadana* (*Ley Trole II*) submitted to congress in mid-July, is to be delayed until end-2000 when the associated loss of tax revenue will be compensated by measures to be included in a forthcoming tax reform (see below).

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[15] Several strikes by public sector workers, including by the powerful teachers union, subsequently have been ended without the government granting additional increases.

[16] The monthly budget allocation for deposit pay-outs is US$12.5 million; deposits in failed banks covered by the guarantee amount to US$929 million, of which about US$150 million is to be paid in cash.

[17] About US$70 million of the projected increase in revenue from the increase in domestic fuel prices would come from fuel oil which is important in electricity generation.

Box 5. Petroleum Derivates Prices and Consumption Subsidies after May 25, 2000

On May 25, 2000 the government announced a package of fiscal measures that included significant increases in the domestic prices of petroleum derivatives. Prices were raised by 65–92 percent for diesel and gasoline, and by 90–333 percent for other derivatives. The price of the 15-kg cylinder of cooking gas was not changed at that time.[1/]

Consumption subsidies (estimated in relation to marginal cost and border prices) were reduced sharply as a result of the price increases, but not fully eliminated for many of the products (see table below).
For example, relative to marginal cost, the 80-octane gasoline consumption subsidy was reduced by 80 percent and that for diesel by 60 percent; these products account for about 90 percent of the petroleum derivatives used in transportation. Subsidies for these two products in relation to border prices were lowered by about 20 percent.

1/ The price of this product was projected to be raised by 40 percent in July and by an additional 40 percent (over the price up to June) in October.

Impact on Subsidies and Government Revenues of the Increase in Selected Gasoline Prices of May 25, 2000

(In U.S. dollars, unless otherwise indicated)

	Pricing Policy 1/				Subsidy per Unit				
					Cash Element		Opportunity Cost Element		Revenue Gains Relative to the Program 4/
	Before	After	Marginal Cost 2/	World Market 3/	Before	After	Before	After	(In millions of U.S. dollars)
80-Octane gasoline	0.40	0.70	0.77	1.80	0.37	0.07	1.40	1.10	8
92-Octane gasoline	0.63	1.04	...	2.24	...	...	1.61	1.20	-2
Diesel	0.27	0.52	0.71	1.36	0.44	0.19	1.09	0.84	26
Jet fuel	0.31	0.81	0.86	...	0.54	0.04	...	...	9
Cooking gas	1.00	1.00	3.14	4.90	2.14	2.14	3.90	3.90	-14
Fuel oil	0.13	0.52	0.17	...	0.04	none	...	...	59
Other products									10
Total									**97**

Sources: Ministry of Finance, Petroecuador, and Fund staff calculations.
1/ Refinery prices per gallon for all items except cooking gas which is per 15-kg cylinder.
2/ Marginal cost set equal to import cost except for jet fuel and fuel oil for which average domestic costs are used instead because Ecuador does not import these products at the time.
3/ Average prices for Bolivia, Peru, and Colombia.
4/ Estimated in relation to the average prices projected under the program for the period June–December 2000.

34. In addition, the government is to continue the policy of eliminating the costly and regressive generalized subsidies on domestic fuels by moving their prices further to international levels. To help alleviate the social impact of the fuel price increases in May (many of which were larger than had been envisaged in the program), the government delayed raising the price of cooking gas, which is important in the household budget of the urban poor. It was agreed that the timetable for further increases in domestic fuel prices would be determined at the time of the second review under the Stand-By Arrangement and, at a minimum, the increase in cooking gas prices that had been scheduled for May would take place in October 2000.

35. At the time of the second review of the Stand-By Arrangement: (i) the fiscal program will be reconsidered to determine how much of any higher than programmed fiscal revenues will go into additional spending on social programs, and how much into deficit and debt reduction; (ii) the performance criteria for end-October and end-December 2000 will be set; and (iii) the level of the ceilings on central government expenditure will be reviewed, in light of the spending programs associated with the fuel price increase and higher than projected inflation. The government stands ready to take any additional steps that may be needed, including further increases in domestic fuel prices, to meet the fiscal objectives of the program.

36. Agreement on an appropriate tax reform will also be a major focus of the second review and is a key component of the structural adjustment loan with the World Bank. In September 2000, the government is to submit to the congress a proposal for a comprehensive reform aimed at increasing revenues from the tax system to help achieve fiscal sustainability while reducing fiscal dependence on oil revenues and distortions from taxation. As indicated in the original memorandum of economic policies, the reform would include: (i) a significant reduction in tax revenue earmarking; (ii) an increase in the rate and coverage of the value-added tax, and a reduction in the exemption threshold for the personal income tax; these measures would be needed to facilitate the abolition of the import tariff surcharge and the financial transactions tax; and (iii) the introduction of a consumption tax on domestic fuels. The latter would be complemented by legislation to be sent to congress this year aimed at liberalizing the production, distribution, retailing, and pricing of domestic fuels.

C. Monetary Policy

37. While the dollarization of the economy proceeded rapidly, there were delays in establishing the mechanisms for providing temporary liquidity to the banking system in the absence of a well functioning inter-bank market and banks continued to have some difficulties in maintaining external credit lines. In addition, restrictive interest rate ceilings on bank loans, and restrictions on bank charges would, unless modified, discourage financial intermediation, undermine efforts to strengthen the banking system, and delay economic recovery.

38. The authorities have clarified the rules for access to the central bank's liquidity recycling facility. However, by end-July the central bank had held only two modest auctions of

central bank bonds, and there had been no need to engage in repurchase agreements to recycle bank liquidity. This partly reflected doubts in the central bank about its legal basis for issuing U.S. dollar-denominated bonds. The authorities have clarified the central bank's legal basis for issuing such bonds in the *Ley Trole II*; in addition, President Noboa agreed to give the central bank political support to engage in liquidity recycling operations. In practice, while the availability of liquidity support and recycling facilities are still very important to provide a cushion against future shocks, they have been less critical than envisaged given the better liquidity position of the banks.

39. During the mission, the *Junta Bancaria* approved regulations establishing the liquidity support facility, and the directorate for the facility was constituted in July. Initial resources for the fund will be a US$40 million disbursement from the Andean Development Corporation (CAF) and 1 percentage point of the reserve requirement on bank deposits (about US$30 million). Collateral for access to the fund is to be priced at market value.

40. The government believes that market imperfections in Ecuador's financial system require the continuation of some form of usury interest rate ceiling. However, it recognizes that the ceiling needs to be implemented in a manner that does not interfere with financial intermediation (in particular, that higher risk customers do not lose access to the formal financial market). To give greater flexibility in setting of interest rates for higher-risk borrowers and to reduce the scope for political pressures that inevitably arose when the central bank was given wide discretion in setting the ceiling, the government has included in the *Ley Trole II* an amendment to the calculation of the usury rate, setting it at 1.5 times the commercial banks average lending rate in the last week of the preceding month. While the staff would have preferred the abolition of the ceiling, it regards this approach as an acceptable second-best solution in which the setting of the cap would be more flexible, less arbitrary and unlikely to interfere with financial intermediation.[18]

41. To further safeguard efficient financial intermediation, the authorities agreed to a substantial reduction in the sliding scale of provisioning that, since last March, commercial banks have been required to make on corporate and household loans that carry interest rates above 18 percent and 23 percent, respectively; the very steep scale made these rates de-facto maximum lending rates. The new scale of provisions was approved by the *Junta Bancaria* in mid-July.[19] In the staff's view, the new provisioning scale still represents an unwarranted

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[18] The proposed formula for the usury ceiling is the one that existed prior to the amendment in the *Ley Trole I*, which set it as the sum of LIBOR plus 4 percent plus a margin for country risk. The commercial banks average lending rate is currently about 15.75 percent, so the ceiling would rise to 23.6 percent upon passage of the legislation and would have the flexibility to rise higher without further intervention should overall lending rates increase.

[19] At interest rates on corporate loans of 18–20 percent, the provision was 15 percent of the loan; at interest rates of 20–22 percent the provision was 25 percent; at interest rates of 22–

(continued...)

disincentive to charging higher rates (albeit one that is much lower than with the original scale) and should be removed as quickly as possible. The authorities have confirmed their intention to allow the special provisioning requirements to expire at end-March 2001. A timetable for removing the restrictions on the fees that can be charged by financial institutions is to be established at the time of the second review.

D. Financial Sector Restructuring

42. The strategy to restructure the banking system, which was designed in collaboration with the staffs of the Fund, World Bank, IDB, and CAF, is described in detail in EBS/00/66. The main elements of the strategy are: (i) establishing the legal basis for bank restructuring; (ii) strengthening the solvency of banks; (iii) facilitating the resolution of closed banks; (iv) strengthening prudential regulation and supervision; and (v) restructuring the viable bank debts of households and the corporate sector. While the framework for an effective restructuring is now largely in place, the delays encountered in 1999–2000 have deepened the banking crisis and increased its ultimate fiscal cost. The key measures and status of actions due for the first review of the Stand-By Arrangement are set out in Appendix I. The discussions focussed mainly on the scheme to restructure the viable bank debts of households and the companies, and measures to provide incentives for the recapitalization of banks from private sources.

43. A restructuring of household and corporate debt to banks is needed to facilitate economic recovery by easing the liquidity position of households and firms, while improving banks' asset quality to facilitate the necessary bank restructuring. The *Ley Trole I* provided for the compulsory restructuring by banks of such debts up to US$50,000 (which accounts for about 12 percent of the value of banks' loan portfolio and 92 percent of banks' clients). The general rules governing the restructuring of debts greater than US$50,000 had been established by presidential decree. During the mission, the *Junta Bancaria* approved detailed regulations implementing a largely voluntary restructuring scheme, acceptable to the staffs of the Fund, World Bank, IDB, and the CAF. The incentives to encourage creditor participation include: (i) a flexible classification system for restructured loans is to be applied to loans entering the scheme to encourage banks to recognize implicit losses; and (ii) the failure to restructure a nonperforming loan within the timeframe provided by the scheme will result in the loan being reclassified as a "loss" with a 100 percent provisioning requirement. To encourage debtor participation, debtors who continue in arrears for more than 90 days after the deadline for restructuring would be subject to special foreclosure procedures (the

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25 percent the provision was 40 percent; and at interest rates above 25 percent the provision was 100 percent. For consumer loans, the same scale of provision started at 23 percent. Under the new rules, the scale would begin at 5 percent of the amount of the loan, rising by 2½ percentage points for each 1 percentage point increase in the interest rate (see the attached supplement to the technical memorandum of understanding).

"*coactiva*"). The authorities will also seek early approval of a resolution facilitating access to "*coactiva*" procedures by private banks.

44. To provide incentives for the recapitalization of banks from private sources, the government has included an amendment to the financial institutions law in the *Ley Trole II* allowing shareholders to retain ownership and control of a bank if its capital adequacy ratio falls below the regulatory minimum of 9 percent, but remains above 1.8 percent, provided a capital strengthening program is agreed with the superintendency of banks.

45. The fiscal cost of the banking crisis at this point—before taking account of possible asset recovery from closed banks—is estimated to be about US$2.6 billion (20 percent of estimated 2000 GDP), with an annual interest carrying cost of about US$195 million (about 1.5 percent of GDP) (Box 6).[20]

E. External Financing and Debt Issues

46. Taking account of committed net external financing (including recent disbursements of program loans from the World bank and the IDB), and the need to clear external payments arrears and to build up a liquidity fund for the banking system, the staff now estimates that Ecuador is facing an external financing gap of about US$1.4 billion (about 9.8 percent of revised GDP) in 2000 (Table 8).

47. Projected additional lending from the World Bank, IDB, and the CAF for the remainder of 2000 includes program loans for a total of US$370 million to support bank recapitalization, improvements in the regulatory structure, and strengthened social programs, leaving a residual financing gap of US$0.9 billion in 2000 (Tables 5 and 9).[21]

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[20] The fiscal costs of the banking crisis are discussed in more detail in the background paper for the Article IV consultation.

[21] The IDB and the CAF disbursed US$79 million and US$30 million of program loans shortly after the Fund's Executive Board approved the Stand-By Arrangement; the World Bank approved a structural adjustment loan of US$151 million in June, and made the first disbursement of US$72 million in July.

Box 6. The Fiscal Cost of the Banking Crisis

In December 1998, prompted by the banking crisis, the government created a deposit insurance agency (AGD) with a broad mandate to restructure the banking system; the government announced also a guarantee on all onshore and offshore deposits and the banking system's external credit lines. However, lack of credibility about the government's ability to sustain the guarantee contributed to a bank run, which led the authorities to declare a bank holiday during March 8–12, 1999 and to freeze demand and savings deposits for six months and time deposits for one year. Following the results of audits by international firms in June 1999, banks with negative net worth were brought under the control of the AGD; four capital-deficient banks were recapitalized with subordinated loans from a state-owned bank; and in October 1999 three of these four banks were intervened by the AGD, or merged with state banks. Overall, during 1998–99, fourteen financial institutions, accounting for about 65 percent of the system's onshore assets, were intervened or closed by the AGD.

The estimated fiscal cost of the banking crisis is about US$2.6 billion (20 percent of GDP), excluding any asset recovery by the AGD. The cost includes bonds issued by the government on behalf of the AGD for about US$1.4 billion. These were used to recapitalize troubled banks, pay out deposit guarantees of failed banks, and cover the run-down of external credit lines. It also includes US$850 million to cover the guaranteed deposits of closed banks, and also about US$155 million to pay these deposits in cash, of which only about US$63 million had been paid (in monthly installments of US$12.5 million) through June 2000. The government has taken over also about US$226 million of nonperforming trade credit lines of AGD banks.

Estimated Cost of the Banking Crisis

(as of June 2000)

	(In millions of U.S. dollars)	(In percent of GDP)
Total	**2,641**	**20.0**
AGD bonds	1,410	10.7
Trade credit lines of AGD banks	226	1.7
Guaranteed deposits of closed banks	850	6.4
Cash provided to cover guaranteed deposits	155	1.2
Memorandum item:		
Estimated total annual "carrying" cost	195	1.5

Source: Fund staff estimates.

48. The authorities are seeking private sector involvement to secure additional external financing to cover the residual gaps. To this end, on July 27, the government launched an offer to exchange new unsecured 30-year "global bonds" for Brady bond and Eurobond debt, aimed at achieving short-term cash-flow relief and medium-term debt reduction (a description of the offer is given in Box 2 and the chronology of events leading up to it is laid out in Box 7).[22] The bond exchange also includes the option of a limited exchange of the 30-year bond for a 12-year bond at an additional debt discount. In 2000, the exchange would provide overall debt service relief of US$238 million, as well as providing substantial debt and debt service reduction over the medium term (see Section H and Appendix II).[23]

49. Obligations to Paris Club creditors in 2000 amount to US$956 million, including arrears of about US$740 million. As noted, the authorities are to meet with Paris Club creditors in early September with a view to reaching agreement on a debt rescheduling. As a minimum, the authorities have indicated that they will seek a rescheduling of arrears, and principal and interest falling due to Paris Club creditors on pre-cutoff date debt (totaling about US$690 million) (Table 10).

50. In June, the government entered into negotiations with a foreign bank with a view to normalizing arrears of about US$218 million on external credit lines of intervened banks. In addition, meetings are ongoing with foreign creditor banks to seek the maintenance of their exposure under interbank and trade-related credit lines, although the authorities expect that concrete action will only be possible once the debt exchange is finalized.

[22] On the eve of the launch of the debt exchange offer, Ecuador had accumulated arrears of about US$220 million on Brady bonds and Eurobonds.

[23] In 2000, a successful debt exchange would allow the authorities to settle obligations of US$565 million (including US$119 million of arrears as of end-1999) by a combination of cash payments (US$140 million), the release of interest collateral (US$186 million), and the issue of a new debt instrument (US$112 million).

Box 7. Chronology of Events Leading to Debt Exchange Offer

In 1996–98, Ecuador accumulated arrears of US$542million to bilateral creditors, but remained current in its obligations to foreign bondholders through the first half of 1999. In the second half of 1999, events unfolded as follows:

- **August 19:** First press reports that the government is considering a renegotiation of the country's external debt.
- **August 23**: Minister of Finance announces the government would approach private creditors to obtain a concerted debt restructuring; the minister emphasized a unilateral moratorium on debt service would not be declared.
- **August 26:** President Mahuad announces that Ecuador will defer the coupon payment on the PDI and Discount Brady bonds for 30 days, and negotiate a restructuring of foreign bonds. IMF issues a press release supporting the government's effort to restructure debt.
- **August 30:** IMF announces agreement *ad referendum* with Ecuador on an economic program that could be supported by a Stand-By Arrangement; subsequently, the agreement breaks down.
- **September 23:** IMF Managing Director states that the Fund has encouraged the government to reach an amicable and market-based resolution to its debt-servicing difficulties.
- **September 26:** The authorities meet with bondholders in New York and announce that the full coupon payment on the (uncollateralized) PDI bonds would be made, and invite the holders of Discount bonds to release the collateral to make possible the coupon payments on these bonds.
- **September 27:** IMF Managing Director issues statement regretting that Ecuador has not found it possible to enter into negotiations with bondholders to reach a comprehensive and collaborative solution.
- **End-September**: the stripped spread on Ecuador's Brady bonds reaches a peak of 4,760 basis points (up from 2,500 basis points at end-July).
- **October 1:** Bondholders vote to reject releasing collateral on Discount bonds and to accelerate the full payment of outstanding interest and principal on all Brady bonds.
- **October 5:** Moody lowers Ecuador's credit rating from B3 to Caa2.
- **October 9:** Authorities announce that US$346 million of U.S. dollar-denominated domestic public debt held by the private sector and maturing between then and end-2000 would be rolled over into seven-year bonds with a two year grace period on amortization and interest rate of LIBOR+2 percent. The bonds previously earned interest of about 10½ percent, implying a "haircut" of about 9 percent in NPV terms.
- **October 20:** The Ecuador Creditors Advisory Group is formed to be the private sector counterpart in discussions with Ecuador on a debt restructuring.
- **October 22:** Authorities announce moratorium on Eurobond debt service.
- **October 28:** First official meeting between Ecuador and private bondholders; authorities present overview of economic situation and announce that negotiations on debt restructuring will commence as soon as agreement has been reached with the IMF on an economic program.
- **November 11:** Second meeting with bondholders takes place; a third meeting is scheduled for December 7, is subsequently postponed and then cancelled.

Key events in 2000 have been:

- **March 21:** Minister of finance suggests that debt-for-equity swaps in state-owned enterprises may be permitted.
- **April 4:** Minister of finance announces renewed effort to reach agreement with private creditors to restructure foreign debt.
- **April 19:** IMF Executive Board approves 12-month Stand-By Arrangement.
- **May 1:** Plenary meeting with bondholders is held in New York.
- **May 16:** Follow-up plenary meeting held with bondholders in New York in which Fund staff present overview of economic program and analysis of Ecuador's medium term viability.
- **May 18:** Authorities meet with the Paris Club creditors and apply for rescheduling on "Houston-plus" terms. Discussions are inconclusive; further discussions are scheduled for July but the authorities later ask for a postponement until September.
- **June:** A new debt negotiating team appointed following the resignation of the minister of finance (in late May).
- **July 27:** Debt exchange offer launched; the offer is supported by a "comfort letter" from Fund management to the international financial community.

F. Structural Reforms

51. Ecuador needs structural reforms to increase the productivity and growth potential of the economy. As described in EBS/00/66, approval by congress last March of the *Ley Fundamental para la Transformación Económica del Ecuador (Trole I)* paved the way for important reforms in three areas:

- **The labor market**, mainly by amending the labor code to allow employment based on temporary contracts for previously unemployed persons; the implementing regulations are expected to be approved by President Noboa shortly.

- **The oil sector**, by allowing private companies to refine, process, and store oil and gas, and to transport them through pipelines (previously a monopoly of the state oil company), as well as build oil pipelines. Two private consortia have bid for the construction of a new oil pipeline from the Amazon region to the Northern coast; a decision has been delayed pending a ruling by the constitutional tribunal as to the constitutionality of greater private sector participation in the oil sector.

- **The privatization** of majority shareholdings in electricity generation, distribution, and transmission companies, and in the two state telecommunications companies. To facilitate privatization, the government has begun to increase electricity and telecommunications tariffs to allow them to reflect real costs.

52. The government intends to deepen the structural reform process through the *Ley para la Promoción de la Inversión y la Participación Ciudadana (Trole II)*. When enacted, the new law will expand the scope of private sector activity, permitting the privatization of public utilities, the state airline (TAME), roads, seaports and airports, postal services, and the extraction of nonrenewable natural resources. The regulatory frameworks for the petroleum, mining, electricity, telecommunications sectors also are to be reformed in order to facilitate privatization and/or joint ventures. Measures also are included to further increase labor market flexibility, including longer probation periods for workers, use of part-time labor, and greater functional mobility for workers within firms (Box 8). The authorities also have clarified intended reforms to the state pension system, aimed at putting it on a firmer financial footing (Box 9).

Box 8. Summary of *Trole II*

The *Ley para la Promoción de la Inversión y la Participación Ciudadana* (*Ley Trole II*), was submitted to congress as emergency legislation on July 13, 2000.1/ It proposes comprehensive reforms to public enterprises, the financial sector, and the labor market. These include:

Public enterprise reforms, concessions, and privatization

- Private firms or joint ventures with state enterprises are to be permitted in the petroleum sector, and the subsidiaries of Petroecuador (the state oil company) are to be converted into publicly-owned corporations. Impediments to free competition in any aspect of the petroleum sector are prohibited.
- The operation and maintenance of a wide range of infrastructure services may be operated on a concession basis by private sector (or mixed private-public) firms. All concession contracts will be open to public bidding.
- The regulatory frameworks are clarified to facilitate privatization of the electricity sector and banks taken over by AGD. The state-owned airline (TAME) will be converted to a corporation within 180 days in order to permit its partial privatization.

Financial sector and central bank reforms

- The central bank is authorized to conduct liquidity recycling operations through issuing U.S. dollar-denominated obligations and conducting repurchase operations.
- Exiting bank owners can retain operational control of banks falling below the minimum capital requirements as long as they comply with restructuring plans agreed with the superintendency of banks.
- Key officials involved in bank supervision are provided more protection from legal prosecution when discharging their duties.
- Banks under control of the AGD will have access to special foreclosure procedures (the *coactiva*) to collect nonperforming loans.
- The usury interest rate ceiling set by the central bank will be set at 1.5 times the average interest rate for corporate loans.

Labor market reforms

- Some categories of workers are permitted to work in more than one type of job within a firm. Hourly contracts are permitted in permanent activities as long as they are for three–six hours daily; in temporary activities, they are permitted up to eight hours daily.
- The concept of unified salary components and the base to calculate severance pay is clarified. Procedures in the national salary council for setting wage scales are reformed.
- Severance pay for "highly paid" workers (above US$500 per month) is limited, and minimum and maximum payments are set private pensions.
- Penalties for noncompliance with minimum wage laws are increased.

1/ The constitution requires that congress votes on an emergency bill within 30 days of it being sent to the congress (in this case, by August 14, 2000).

Box 9. Pension System: Current Situation and Reform Proposal

The Ecuadoran social security institute (IESS) administers various programs including retirement and disability pensions, health insurance, peasants' social insurance, and workers' compensation. Since 1987, use of the contributions to the different systems has been pooled creating a complex web of cross subsidies. There have been no externally certified financial statements of the IESS since 1995, and there is no comprehensive inventory of its assets, nor a clear allocation of assets to the various systems. An important step in improving the administration of the various systems was taken in 1999, by the budgetary separation of their operations. In 1999, the systems incurred a combined cash deficit of US$26 million, mainly because of deficits in the pensions and health components. Cash flow projections of the pension system for the next 15–20 years suggest that such deficits would persist under the current structure of benefits and contributions.

Various factors underlie this situation:

- The pension program was designed to operate as a pay-as-you-go (PAYG), defined-benefits system supplemented by central government budgetary transfers equivalent to 40 percent of the pensions paid. In practice, much smaller transfers have been received since 1985;

- The structure of contributions and benefits is unbalanced, and the links between contribution and benefits are weak. The system provides for a minimum pension and benefits are capped at about US$85 a month. The latter feature has lead to the underreporting of salaries. Until recently, payroll taxes were levied on a small fraction of the total salary package, so only 28 percent of the pension benefits were funded by contributions in 1999;

- Reflecting in part the maturation of the system and the rise in the informal sector of the economy, the dependency ratio rose from less than 2 percent in its early years to about 12 percent in 1999.

The government has submitted to congress a comprehensive reform proposal:[1/]

- The new system will have three components: (i) a PAYG to provide for a minimum pension. Benefit payments will grow the later a person retires and the longer he contributes. Operations will be funded by a 3.5 percent contribution paid by the employer irrespective of the wage level, and 5 percent paid by the employee up to monthly wages of US$60; (ii) a mandatory individual account funded by a 5 percent contribution paid by the employee on the amount exceeding US$60 up to US$200; and (iii) a voluntary employee contribution on amounts exceeding US$200. Administration of funds under (ii) and (iii) will be open to private sector companies.

- The overall mandatory contribution rate (employer and employee) will be left almost unchanged at 8.5 percent;

- The minimum retirement age will be raised from 55 to 60 years, and the special early retirement option will be eliminated; and

- Current contributors up to 40 years old must move into the new system; those between 40 and 50 years old can choose to stay in the current system or move to the new one, and those older than 50 must stay in the old system.

1/ This reform is being supported by the Interamerican Development Bank.

53. Ecuador, which joined the WTO in 1996, has a moderately restrictive trade regime.[24] Prior to the imposition of a system of import surcharges in March 1998, the average import tariff was about 11½ percent. The surcharges, which were introduced for fiscal reasons, were increased in February 1999 and now consist of seven ad valorem rates ranging from 2 to 10 percent; there have been frequent changes in coverage. Including the surcharges, the average import tariff is over 15 percent. In May 2000, import tariff rates on a number of items were reduced (see paragraph 22 above). In the memorandum of economic policies accompanying the request for a Stand-By Arrangement, the government indicated its intention to abolish the import tariff surcharge as part of the broader tax reform planned for implementation with the 2001 budget.

G. Statistical Issues

54. Ecuador continues to provide the core minimum data to the Fund on a regular basis. It has subscribed to the Special Data Dissemination Standard, and its metadata are posted on the Dissemination Standards Bulletin Board. The macroeconomic database is deficient with respect to the national accounts, balance of payments, and government finance statistics; data on poverty and income distribution are also poor. At the authorities' request, STA provided assistance in preparing revised monetary and credit aggregates in accordance with the new exchange system. The authorities also have implemented improvements in the coverage and timeliness of the monitoring system of banks' external credit lines, which had been set up with technical assistance from PDR. In the staff's view, Ecuador's data deficiencies do not fundamentally hamper surveillance or the design, implementation and monitoring of a Fund supported program.

H. Medium-Term Outlook

55. An assessment of the medium-term outlook is presented in Appendix I. The baseline scenario suggests that, even in the presence of a large fiscal effort (with sustained primary surpluses well above Ecuador's past experience), the indicators of public debt and debt service in relation to exports of goods and nonfactor services and to fiscal revenues would remain extremely high. The staff's estimates of the impact on this baseline of the debt exchange are based on the assumptions that: (i) 100 percent of holders of Brady bonds and Eurobonds take up the offer; and (ii) the required "buybacks" before the final maturity on the 12-year and 30-year "global bonds" issued in exchange take place at full face value. (The latter is a relatively conservative assumption because, if the debt were to be trading at full market value, Ecuador presumably would not have difficulty accessing the market at that time.) The projections

[24] Ecuador is rated 6 on the Fund's 10-point trade restrictiveness index (with "1" the least restrictive and "10" the most restrictive). External trade issues are discussed in more detail in the background paper for the Article IV consultation.

suggest the debt exchange offer would make a sizable contribution to close the projected external financing gaps over the medium-term. Specifically:

- The face value reduction in the stock of debt to bondholders would be about 41 percent (assuming full take-up on the 12-year bond).

- The external financing gap for 2000 would largely be eliminated, provided that the Paris Club agrees to reschedule in line with program assumptions.[25]

- Further assistance would be needed from official creditors sufficient to close the projected financing gaps for 2001–03; thereafter, provided that a strong fiscal effort is maintained, the remaining financing gaps should be manageable; they would be closed if the bond buybacks scheduled to begin in 2006 take the form of debt-equity swaps rather than cash payments.

- After the exchange, debt service in relation to exports of goods and nonfactor services would fall sharply, by about 8–10 percentage points a year during 2001–11.

- The fiscal financing gap in 2000 would be largely eliminated; there would still be a fiscal financing gap in the next three years but it would stem mainly from principal payments on maturing domestic debt, which would need to be either restructured or refinanced.

56. These conclusions are sensitive to a change in oil export prices, but relatively insensitive to an increase in interest rates because of the fixed coupon payment of the new global bond. A substantially lower oil price than assumed in the projections[26] would leave continued financing gaps (e.g., the external gap would widen by about US$100 million a year for each US$1 decline in the oil price), while a higher price would allow the gaps to be closed more quickly.

[25] The financial program assumes clearance of arrears on post-cutoff date debt (which amounted to US$49 million at end-May), and a rescheduling of arrears, principal and interest on pre-cutoff date debt (except for the sixth Paris Club rescheduling) of about US$650 million.

[26] The medium-term petroleum price projections are based on the price level projected for Ecuador's mix in 2000 (US$22 per barrel) and WEO's projected annual rate of change of petroleum prices thereafter. In the last few years, Ecuador's mix sold for about US$3–4 a barrel less than WEO's.

IV. Staff Appraisal

57. Ecuador's economic performance under the Stand-By Arrangement has been better than expected in very difficult circumstances. The decline in economic activity appears to have bottomed out at last; the fiscal performance and external positions are stronger than programmed; the immediate pressures on the banking system have eased; dollarization is proceeding rapidly; and relations with external creditors have moved forward with the launch in July of a debt exchange offer which should contribute to the attainment of fiscal and external sustainability over the medium term.

58. All the quantitative performance criteria for end-April were met with the exception of that for domestic non-interest payments arrears, and staff expect that all quantitative performance criteria for end-June also were met, again with the exception of that on domestic arrears for which the authorities request a waiver. Preliminary indications are that the structural performance criteria for end-June were also met, with the exception of that on cooking gas prices. However, the package of increases in domestic fuel prices implemented in May was, on average, significantly higher than envisaged under the program, even though cooking gas prices were not raised.

59. The improved fiscal outlook reflects steps to reduce wasteful and costly generalized fuel subsidies and improvements in tax administration, but also higher than programmed inflation and oil export prices, and the under-execution of investment projects. The tax reform that the authorities plan to send to the congress in September will need to focus on measures that reduce fiscal dependence on oil revenues, and mobilize additional revenue to offset losses from the planned phasing out at the end of this year of the financial transactions tax and the import tariff surcharge, strengthen the social safety net, and provide for further fiscal adjustment next year. A large reduction in tax revenue earmarking should also be part of the reform in order to give more flexibility to fiscal policy. The shortfall in capital spending is unfortunate given the downgrading of the country's infrastructure following large cuts in spending programs in recent years. Implementation capacity needs to be improved substantially to ensure that capital spending gives added support to economic activity and poverty alleviation.

60. The progress with respect to the banking strategy is welcome. Of particular importance were the approval by the *Junta Bancaria* of the implementing regulations for a voluntary, case-by-case approach to restructuring the debt to banks of households and corporations, and the setting up of bank liquidity support facilities. A successful restructuring of these debts is essential to the strategy for strengthening the banking system, minimizing the fiscal costs of the crisis, and laying the basis for economic recovery. Implementing the debt restructuring scheme along the agreed lines will be a further test of the government's political resolve given the pressures from the household and corporate sector for a more generous treatment. Such pressures need to be resisted since they would raise the fiscal costs of the banking crisis. Although the liquidity support facilities have been less critical so far (given the

better liquidity position of the banks), they still are needed to provide a cushion in the event of future pressures. The central bank will need firm political backing for the effective implementation of liquidity assistance policies in the current environment. The revised regulations governing interest rate caps and to reduce special provisioning requirements will introduce greater flexibility in setting lending rates for higher-risk borrowers; however, the remaining restrictions are still unwarranted and should be removed as quickly as possible.

61. The authorities efforts to advance the structural reform process are welcome. Congressional approval of the *Ley Trole II* along the lines proposed by the government will facilitate the privatization of a wide range of public utilities and enterprises (including TAME, the state airline), improve the regulatory frameworks for privatized activities, and increase labor market flexibility. Ecuador lags far behind other countries in Latin America in implementing such reforms, at considerable cost to long-run gains in productivity and output potential.

62. With the launching of the debt exchange offer in late July, the authorities took an important initiative in reaching a cooperative solution with private creditors to secure financing for the program, and to achieve external and fiscal sustainability over the medium term. To fully normalize relations with external creditors, the authorities need to move ahead quickly on three fronts. First, more rapid progress with foreign banks is needed to seek the maintenance of their exposure under interbank and trade-related credit lines, and to clear the arrears on credit lines of intervened banks. The lack of progress in this respect is a hindrance to economic recovery. Second, the authorities need to find appropriate mechanisms—which could include refinancing, a roll-over, or restructuring—to close the remaining fiscal financing gaps over the next three years that stem from maturing domestic debt (held mainly by the banking sector). Finally, at the meeting with Paris Club creditors in early September, the authorities need to reach agreement on a rescheduling of obligations. The medium-term projections show that, even with a successful debt exchange, continuation of a strong fiscal effort, with little room for policy slippage, will be needed to achieve a sustainable fiscal and external position.

63. Although Ecuador's macroeconomic database is adequate for surveillance, the authorities need to address problems with respect to the general timeliness of fiscal data, and the accuracy of data on domestic government debt and the external obligations of banks that have been intervened by the AGD.

64. The government's room for maneuver remains limited by the divided congress, and its resolve will be tested further in the coming months (particularly in the implementation of restructuring of household and corporate debt), but on balance, the risks to achievement of the program's objectives—while still substantial—have diminished since Executive Board approval of the arrangement in April:

- There has been an improvement in cooperation with the Fund.

- The government has demonstrated political resolve with the implementation of the fuel price increases.

- The debt exchange will help make the short-run external position viable, and the long run position more sustainable, provided the fiscal effort is maintained.

- While the banking system remains fragile, the likelihood of a major run on deposits appears to have diminished.

- However, there is no room for policy slippages. In particular, all parts of Ecuador's political system need to recognize that there is no substitute for the difficult policy decisions needed to keep fiscal deficits low and to create a more robust financial sector. Without these decisions, the hard-won gains of recent months will not be sustained.

65. In light of the progress that has been made to date in implementing the program, the staff would support a waiver for the nonobservance of the performance criteria on domestic non-interest payments arrears and cooking gas prices, and, once the remaining prior actions are implemented, would recommend completion of the first review of the Stand-By Arrangement. The staff also recommends that the exchange restriction under Article VIII, section 2(a), resulting from the freeze on bank deposits, be approved for a further 12-months on the basis that the freeze was temporary, justified by balance of payments need, and nondiscriminatory.

66. It is envisaged that the second review under the program will be held before end-September 2000, and that the next Article IV consultation will be held on the standard 12-month cycle.

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

A. Review of Stand-By Arrangement[27]

1. Ecuador has consulted with the Fund in accordance with paragraph 3(c) of the Stand-By Arrangement for Ecuador (EBS/00/66, Supplement 2) and paragraph 2 of the letter dated April 4, 2000 from the Minister of Finance and Public Credit and the President of the Board of the Central Bank of Ecuador, in order to review the implementation of, and the financing assurances for, the program.

2. The letter from the Minister of Economy and Finance and the President of the Board of the Central Bank of Ecuador, dated August 10, 2000, with its attached Supplement to the Memorandum of Economic Policies of the Government of Ecuador (the "Supplement Memorandum"), shall be attached to the Stand-by Arrangement for Ecuador, and the letter dated April 4, 2000 and its annexed Memorandum of Economic Policies of the Government of Ecuador for 2000 shall be read as supplemented and modified by the letter dated August 10, 2000 and its attached Supplement Memorandum.

[27] After completion of prior actions.

3 Accordingly,

a. Paragraph 2 of the Stand-By Arrangement for Ecuador shall be deleted in its entirety and replaced with the following:

"2. Purchases under this Stand-By Arrangement shall not, without the consent of the Fund, exceed the equivalent of SDR 85 million until June 15, 2000, the equivalent of SDR 113.346 million until October 15, 2000, the equivalent of SDR 151.14 million until December 15, 2000, and the equivalent of SDR 188.935 million until February 15, 2001."

b. Paragraph 3(c) of the Stand-By Arrangement for Ecuador shall be amended by:

(i) deleting "August 14, 2000" after "June 14, 2000"; and

(ii) adding the following after "contemplated in paragraph 2 of the attached letter": "and in paragraph 2 of the letter dated August 10, 2000,".

4. The performance criterion set out in paragraph 3(a)(vi) for August 31, 2000 shall be as specified in Table 1 of the Supplement Memorandum.

5. The Fund decides that the first review contemplated in paragraph 3(c) of the Stand-By Arrangement for Ecuador has been completed and that Ecuador may proceed to make purchases in accordance with the provisions of the Stand-by Arrangement, as amended ,

notwithstanding the non-observance of the performance criteria specified in paragraph 3 (a) (iv) and (b) (i) of the Stand-By Arrangement for Ecuador.

B. Exchange System

6. The freeze on demand and savings deposits with the banking system imposed by Ecuador gives rise to an exchange restriction subject to Fund approval under Article VIII, Section 2(a). In view of Ecuador's intention to eliminate this exchange restriction, the Fund approves the retention by Ecuador of this restriction until September 1, 2001, or the conclusion of the next Article IV consultation with Ecuador, whichever is earlier.

Table 1. Ecuador: Selected Economic and Financial Indicators

	1996	1997	1998	Prel. 1999	Program 2000 Orig.	Program 2000 Rev.
	(Annual percentage changes; unless otherwise indicated)					
National income and prices						
GDP at constant prices	2.0	3.4	0.4	-8.0	0.0	0.5
Oil sector production	-2.0	3.5	-3.4	-4.9	3.7	3.7
Non-oil sector	2.6	3.4	1.0	-8.5	-0.6	0.0
Real per capita GDP	-0.1	1.3	-1.6	-9.8	-1.9	-1.4
Consumer prices (average)	24.4	30.6	36.1	52.2	74.0	100.6
Consumer prices (end-of-period)	25.5	30.7	43.4	60.7	60.0	94.1
External sector (in terms of U.S. dollars)						
Exports, f.o.b.	11.1	7.4	-20.2	-1.0	5.3	3.6
Petroleum exports	13.8	-12.3	-40.7	47.5	37.5	35.3
Imports, f.o.b.	-2.7	18.2	11.4	-50.1	20.7	11.7
Export volume	4.5	9.2	-3.4	-5.5	-5.4	-6.3
Non-oil export volume	10.7	11.0	-3.8	-4.9	-11.4	-8.9
Import volume	0.0	24.6	16.0	-49.4	19.6	9.3
Terms of trade (deterioration -)	9.2	3.6	-13.3	6.6	4.7	10.2
Non-oil	1.7	12.6	-3.8	-8.9	0.3	-4.8
Real effective exchange rate (depreciation -)	1.4	14.2	-8.6	-36.4	...	...
Money and credit						
Banking system						
Net domestic assets 1/	33.6	35.2	33.8	19.2	-14.3	-10.9
Of which:						
Credit to public sector 1/ 2/	-1.8	2.3	10.1	-11.8	-24.6	-1.4
Credit to private sector 1/	15.6	23.7	5.9	-20.3	3.4	1.1
Money and quasi-money (M2) 3/	38.0	28.6	26.8	19.8	-28.2	10.5
Velocity (GDP relative to M2) 3/ 4/	4.0	3.8	3.7	3.3	4.5	3.7
Interest rate (90-day CDs, in percent) 5/	33.5	31.5	49.5	47.7	...	...
	(In percent of GDP)					
Public sector savings	4.6	3.7	-0.3	1.1	4.2	3.9
Nonfinancial public sector balance 6/7/	-3.1	-2.6	-6.2	-6.0	-3.9	-2.7
Quasi-fiscal result of the central bank	0.2	0.1	0.3	-1.2	0.7	0.1
Combined public sector balance 6/7/	-3.0	-2.4	-5.9	-7.2	-3.2	-2.7
Gross domestic investment	17.3	20.2	24.7	11.2	16.1	14.7
Gross national savings	16.6	16.6	13.7	17.5	19.2	19.2
External current account deficit 8/	0.7	3.6	11.0	-6.3	-3.1	-2.0
External debt (end-of-year) 8/9/	76.2	76.9	82.2	116.2	148.0	135.0
Of which:						
Public external debt 8/9/	65.9	64.2	66.2	97.2	138.1	111.0
	(In percent of exports of goods and nonfactor services; unless otherwise indicated)					
Public sector debt service 9/	25.4	26.8	30.0	29.3	33.4	32.0
Of which:						
Interest payments	12.3	12.2	15.6	16.3	16.1	18.7
Outstanding use of Fund resources (in percent of quota at end-of-period)	46.0	45.1	22.6	0.0	65.6	62.5
Net official reserves 10/	5.0	4.6	3.3	4.4	1.3	2.6

Sources: Ministry of Finance; Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Change in relation to liabilities to the private sector 12 months earlier.

2/ The 2000 figure is not comparable to those of preceeding years because of changes in the classification of accounts at the central bank.

3/ The figure for 2000 reflects the impact on M2 of the unfreezing of time deposits with bonds.

4/ Velocity is measured in relation to the 12-month average monthly stock of M2, with the U.S. dollar components valued at end-of-period exchange rates.

5/ Nominal average interest rate on all 90-days time deposits held in private banks in the last week of the year.

6/ Includes interest payments on an accrual basis and the change in the floating debt of the treasury.

7/ Measured from below the line.

8/ Includes interest on external arrears to commercial banks.

9/ Includes obligations to the Fund.

10/ In months of imports of goods and nonfactor services; in 2000 it refers to the stock of free disposable international reserves after providing backing for central bank liabilities as mandated by law.

Table 2. Ecuador: Proposed Rescheduling of Purchases Under the Stand-By Arrangement 2000

Date	Amount In Millions of SDRs	In percent of Quota	Conditions
April 2000	85.000	28.12	Board approval.
August 2000 1/	28.345	9.38	Observance of end-June 2000 performance criteria and completion of first review.
October 2000	37.795	12.50	Observance of end-August 2000 performance criteria and completion of second review.
December 2000	37.795	12.50	Observance of end-October 2000 performance criteria and completion of third review.
February 2001	37.795	12.50	Observance of end-December 2000 performance criteria and completion of fourth review.
Total access	**226.725**	**75.00**	

Source: Fund staff estimates.

1/ Refers to purchase originally scheduled for June 2000 upon completion of first review.

Table 3. Ecuador: Quantitative Performance Criteria and Indicative Targets for 2000 1/

(In millions of U.S. dollars)

	Prel.	Program			
	Apr.	Jun.	Aug.	Oct. 6/	Dec. 6/
1. Cumulative combined public sector borrowing requirement					
Program	317	323	426	368	355
Actual	-25				
Margin (+ observed)	342				
2. Cumulative nonfinancial public sector borrowing requirement					
Program	310	337	462	424	431
Revised program 2/	310	347	452	407	371
Actual	-11				
Margin (+ observed)	321				
3. Cumulative total central government expenditure					
Program	995	1,417	1,964	2,385	2,857
Revised program 2/	995	1,428	1,955	2,368	2,797
Actual	865				
Margin (+ observed)	130				
4. Cumulative net reduction in central government non-interest domestic arrears					
Program	0	2	3	5	6
Actual	-39				
Margin (- observed)	39				
5. Cumulative disbursements of medium- and long-term external debt to the nonfinancial public sector:					
maturity of over one year					
Program	290	510	610	700	850
Actual	204				
Margin (+ observed)	86				
maturity of one to five years					
Program	40	60	70	90	100
Actual	0				
Margin	40				
6. Stock of net "excess" freely disposable international reserves of the central bank					
Program	187	155	101	154	205
Adjusted program 3/	166				
Actual	256				
Margin (- observed)	-90				
7. Stock of nonfinancial public sector deposits at the central bank 4/					
Program	334	416	411	440	487
Revised program 3/5/	486	589	584	613	660
Actual	671				
Margin (- observed)	-184				

Sources: Central Bank of Ecuador, Ministry of Economy and Finance of Ecuador, and Fund staff estimates.

1/ As defined in the attached Technical Memorandum of Understanding.

2/ The program targets were revised from May onwards to reflect an agreement between the Central Bank and the Ministry of the Economy and Finance to lower the interest and extend the maturities of AGD bonds held by the former.

3/ The program target was adjusted downwards by the shortfall in disbursements in program loans (US$61 million) and adjusted upwards by the accumulation of nonrescheduleable arrears (US$39 million).

4/ Indicative target.

5/ The program indicative targets were revised upwards by US$173.4 million at each test date to reflect a change in reporting government deposits at the central bank.

6/ Targets 1-6 are indicative and will be changed to performance criteria during the second review.

Table 4. Ecuador: Summary of Public Sector Operations

	1997	1998	1999	Jan.-Apr. 2000 Prog.	Jan.-Apr. 2000 Prel.	Program 2000 Orig. 1/	Program 2000 Rev.
	(In millions of U.S. dollars)						
Total revenue	**4,665**	**4,001**	**3,444**	**933**	**1,089**	**3,139**	**3,533**
Petroleum revenue	**1,265**	**906**	**1,039**	**327**	**397**	**1,165**	**1,412**
Nonpetroleum revenue	**3,092**	**3,077**	**2,273**	**560**	**666**	**1,870**	**1,999**
Tax revenue	1,844	1,982	1,517	389	494	1,363	1,487
Social security contributions	453	443	228	39	48	139	158
Other	795	652	528	132	123	368	354
Operating surplus of public enterprises	**309**	**18**	**131**	**46**	**27**	**104**	**123**
Total expenditure	**5,170**	**5,216**	**4,244**	**1,243**	**1,100**	**3,569**	**3,907**
Current expenditure	**3,925**	**4,059**	**3,292**	**911**	**904**	**2,680**	**3,025**
Interest accruals	1,014	979	1,348	449	428	1,153	1,109
Wages and salaries	1,536	1,678	982	197	175	673	837
Purchases of goods and services	598	582	393	97	102	319	430
Other	777	820	569	168	198	534	649
Capital expenditure	1,245	1,158	952	332	195	890	881
Primary balance	509	-236	547	139	418	723	735
Overall balance	-504	-1,215	-800	-309	-11	-431	-374
Central bank quasi-fiscal result	21	60	-166	-8	14	75	19
Combined balance	-483	-1,155	-966	-317	3	-355	-355
	(In percent of GDP)						
Total revenue	23.6	20.3	25.0	7.1	8.3	28.7	26.8
Petroleum revenue	6.4	4.6	7.5	2.5	3.0	10.6	10.7
Nonpetroleum revenue	15.6	15.6	16.5	4.2	5.0	17.1	15.2
Tax revenue	9.3	10.0	11.0	3.0	3.7	12.5	11.3
Social security contributions	2.3	2.2	1.7	0.3	0.4	1.3	1.2
Other	4.0	3.3	3.8	1.0	0.9	3.4	2.7
Operating surplus of public enterprises	1.6	0.1	1.0	0.4	0.2	1.0	0.9
Total expenditure	26.2	26.4	30.8	9.4	8.3	32.6	29.6
Current expenditure	19.9	20.6	23.9	6.9	6.9	24.5	22.9
Interest accruals	5.1	5.0	9.8	3.4	3.2	10.5	8.4
Wages and salaries	7.8	8.5	7.1	1.5	1.3	6.2	6.3
Purchases of goods and services	3.0	2.9	2.9	0.7	0.8	2.9	3.3
Other	3.9	4.2	4.1	1.3	1.5	4.9	4.9
Capital expenditure	6.3	5.9	6.9	2.5	1.5	8.1	6.7
Primary balance	2.6	-1.2	4.0	1.1	3.2	6.6	5.6
Overall balance	-2.6	-6.2	-5.8	-2.3	-0.1	-3.9	-2.8
Central bank quasi-fiscal result	0.1	0.3	-1.2	-0.1	0.1	0.7	0.1
Combined balance	-2.4	-5.9	-7.0	-2.4	0.0	-3.2	-2.7
Memorandum item:							
Nominal GDP (in millions of U.S. dollars)	19,769	19,741	13,769	13,190	13,190	10,942	13,190

Sources: Ministry of the Economy and Finance; Central Bank of Ecuador, and Fund staff estimates and projections.

1/ Ratios in percent of original program GDP.

Table 5. Ecuador: Financing of the Nonfinancial Public Sector, 2000

	Annual total	
	(In millions of U.S. dollars)	(In percent of GDP)
Primary balance	**735**	**5.6**
Net domestic requirements	**-632**	**-4.8**
Interest due	-288	-2.2
Amortization of domestic bonds	-431	-3.3
Net change in domestic payments arrears	-11	-0.1
Domestic bond issues	9	0.1
Restructuring of domestic bonds	224	1.7
Private sector financing of Petroecuador	111	0.8
Other domestic financing 1/	-10	-0.1
Change in deposits at the central bank (- increase) 2/	-235	-1.8
Net external requirements	**-998**	**-7.6**
Interest due	-821	-6.2
Amortization due	-559	-4.2
Net change in external payments arrears	-852	-6.5
Capitalization of Brady PDI bond interest	88	0.7
Disbursements on project loans	473	3.6
Emergency program financing 3/	487	3.7
Release of Brady Bond interest collateral	186	1.4
Nonfinancial public sector residual financing gap	**-894**	**-6.8**

Sources: Ministry of the Economy and Finance; Central Bank of Ecuador; and Fund staff estimates.

1/ Interest payments to the central bank made ahead of schedule that were earmarked to pay central bank debt to the Latin American Reserves Fund (FLAR).

2/ Excludes the effect of the release of the interest collateral of Brady bonds (US$186 million) registered under external resources. It is reported as a decline in deposits and a reduction in other net assets in the central bank accounts.

3/ Emergency program financing from the World Bank, Interamerican Development Bank, and the Andean Development Corporation.

Table 6. Ecuador: Summary Accounts of the Banking System under Dollarization, 1999-2000

(In millions of U.S. dollars, unless otherwise noted)

	Dec. 1999	2000 Mar.	2000 Apr.	2000 Jun. Prog.	2000 Jun. Prel.	2000 Dec. Orig. Prog.	2000 Dec. Rev.
I. Central Bank							
Freely disposable net international reserves	**872**	**778**	**938**	**760**	**890**	**835**	**657**
Net domestic assets	**254**	**-137**	**-368**	**-312**	**-522**	**-479**	**-386**
Net credit to the nonfinancial public sector	979	878	816	958	633	849	936
Holdings of AGD bonds	1,315	1,284	1,323	1,230	1,313	1,230	1,313
Other credits	164	153	154	201	155	189	142
Deposits and other liabilities	-500	-559	-660	-473	-834	-570	-519
Net credit to the banking system	412	306	256	264	250	202	239
Of which: Repo operations	59	35	8	246	1	225	100
Of which: US$-CBE paper	0	0	0	-164	0	-204	-76
Other assets net	-1,138	-1,321	-1,441	-1,533	-1,406	-1,530	-1,561
Of which: US$-CBE paper	0	0	0	-26	0	-26	0
Of which: Outstanding purchases from the IMF	0	0	-112	-157	-116	-274	-182
Central bank fully backed sucre liabilities	**1,126**	**641**	**570**	**448**	**368**	**356**	**271**
Currency issue 1/	578	425	339	330	153	245	74
Bankers deposits	192	206	224	114	212	111	197
Sucre-denominated CBE bonds	356	10	7	3	3	0	0
II. Banking System							
Net foreign assets	**-224**	**5**	**-50**	**-183**	**44**	**-170**	**-95**
Net domestic assets	**3,497**	**3,136**	**3,369**	**3,294**	**3,547**	**3,295**	**3,962**
Net central bank credit	149	53	142	-142	96	-97	59
Of which: Cash	113	101	115	33	108	24	134
Net credit to nonfinancial public sector	312	282	250	-361	326	-544	304
Of which: "Unfreezing bonds" 2/	0	0	0	-619	0	-788	0
Net credit to the private sector	2,508	2,156	2,173	2,406	2,154	2,544	2,547
Other domestic assets	528	644	805	1,391	972	1,391	1,052
Liabilities to the private sector	**3,273**	**3,141**	**3,320**	**3,111**	**3,591**	**3,125**	**3,867**
Of which: Deposits 2/	2,878	2,787	2,961	2,007	3,238	1,887	3,513
III. Consolidated Banking System							
Net foreign assets	**648**	**784**	**888**	**577**	**935**	**665**	**562**
Net domestic assets	**2,986**	**2,692**	**2,736**	**2,832**	**2,794**	**2,680**	**3,371**
Net credit to the nonfinancial public sector 2/	1,291	1,161	1,066	597	959	306	1,240
Net credit to the private sector	2,508	2,156	2,173	2,406	2,154	2,544	2,547
Other net domestic assets	-813	-624	-503	-171	-318	-169	-416
Liabilities to the private sector	**3,634**	**3,476**	**3,625**	**3,409**	**3,729**	**3,345**	**3,933**
M_2 2/	3,240	3,123	3,266	2,304	3,375	2,108	3,579
M_1	933	1,031	1,003	629	956	582	961
Quasi-money 2/	2,307	2,091	2,263	1,676	2,419	1,525	2,618
Other liabilities	395	353	359	1,104	353	1,237	353
Memorandum items:							
(Percentage change over December of the previous year)							
M_2 3/	85.3	-3.6	0.8	-28.9	4.2	-28.2	10.5
M_1	88.6	237.9	198.1	-32.6	2.5	-5.0	3.0
Net credit to private sector 3/	60.6	-36.1	-34.9	-4.1	-14.1	4.9	1.6
"Excess" freely disposable international reserves 4/							
(in millions of US$) 5/	-254	137	256	469	406	205	205
(in percent of:)							
US$-denominated CBE paper		...	...	81.7	...	88.8	268.4
Government deposits	-50.9	24.6	38.8	32.8	48.7	35.9	39.5
Both liabilities	-50.9	24.6	38.8	23.4	48.7	25.6	34.4

Sources: Central Bank of Ecuador; Fund staff estimates and projections.

1/ Reflects actual and projected redemption of sucre bills for U.S. dollars.

2/ Reflects the effects of unfreezing time deposits and the payment of the deposit guarantee in closed banks with government bonds.

3/ The figures corresponding to 1999 are based on end-of-period exchange rate for valuing dollar denominated components.

4/ "Excess" freely disposable international reserves are those reserves held by the CBE in excess of those required to back currency issue, sucre-denominated CBE bonds, and bankers deposits at the CBE., minus outstanding IMF purchases also.

5/ The negative number for end-1999 means that dollarization with full backing of the CBE sucre liabilities could not have been implemented at an exchange rate of S/.25,000 per US$ with the freely disposable reserves held by the CBE at end-1999.

Table 7. Ecuador: Summary of the Accounting Systems of the Central Bank of Ecuador, 1999-2000

(In millions of U.S. dollars; end of period)

	1999	2000 Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul. 25
I. Exchange system account 1/	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
FDIR 2/	577.9	457.3	442.7	425.0	339.0	237.4	152.8	111.1
Currency issue (C)	-577.9	-457.3	-442.7	-425.0	-339.0	-237.4	-152.8	-111.1
II. Financial reserve system account	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
FDIR 2/	548.5	350.2	363.8	216.1	230.9	205.0	215.2	185.3
Reserve requirements and other bank deposits (BD)	-192.3	-158.6	-124.6	-206.2	-223.9	-202.0	-212.2	-182.4
Central bank sucre-bonds (BEMs)	-356.1	-191.6	-239.2	-10.0	-7.0	-3.1	-3.1	-2.9
III. Operations system account	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
FDIR 2/	-254.2	44.6	102.7	137.3	368.3	448.0	522.4	590.1
Repurchase-operations	60.3	33.9	33.9	35.8	8.2	7.4	1.2	0.6
US$-denominated central bank paper								
Government bonds	1,017.0	697.7	684.6	700.1	708.8	698.2	706.8	668.9
Nonfinancial public sector deposits	-499.8	-457.0	-512.0	-559.2	-660.5	-760.3	-834.2	-866.9
Medium- and long-term debt of the central bank (FLAR)	-303.7	-294.0	-283.5	-285.6	-277.9	-268.3	-268.2	-268.2
Outstanding purchases from the IMF (IMF)					-112.1	-113.8	-116.4	-109.9
Private sector deposits	-19.5	-25.2	-25.6	-28.3	-34.8	-11.2	-11.5	-14.6
IV. Residual accounts	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Other domestic and foreign assets	1,336.7	1,555.7	1,585.3	1,600.4	1,628.7	1,636.0	1,649.9	1,644.0
Other domestic and foreign liabilities	1,379.7	1,601.6	1,626.8	1,600.4	1,628.8	1,636.0	1,649.9	1,644.0
Gold valuation differences	43.0	45.9	41.5	0.0	0.0	0.0	0.0	0.0
Memorandum item:								
Performance criteria variable:								
"Excess" freely disposable international reserves 4/	-254.2	44.6	102.7	137.3	256.2	334.2	406.0	480.2
Program	-254.3	44.6	85.7	221.8	186.8	126.4	155.3	...

Sources: Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Currency issue, banks' deposits at the central bank, and central bank sucre-denominated debt are legally required to be fully backed by freely disposable international reserves (FDIR).

2/ FDIR is defined as the sum of monetary gold, deposits in foreign banks and other financial intermediaries, freely convertible bills and coins, investments in time deposits and fixed income instruments, holdings of SDRs, reserve position at the IMF and in ALADI, minus reserve liabilities including gold swaps operations, and foreign loans with a maturity of up to one year.

3/ Gold holdings included in FDIR are valued at current world market prices; the difference between the central bank's valuation (US$400 per troy ounce) and the market price is reported in this line. From end-March onward, the central bank values all its monetary holdings at international prices.

4/ The performance criteria variable "excess" FDIR = FDIR - (C+BD+BEMs+IMF)

Table 8. Ecuador: Summary Balance of Payments 1996-2000

	1996	1997	1998	1999	Program 2000 Orig.	Program 2000 Rev.
(In millions of U.S. dollars)						
Current account	**-140**	**-713**	**-2,170**	**955**	**220**	**423**
Trade account	953	598	-995	1,665	1,249	1,498
Exports, f.o.b.	4,900	5,264	4,203	4,451	4,384	4,611
Of which: Petroleum products	1,776	1,557	923	1,480	1,873	2,002
Imports (f.o.b.)	-3,947	-4,666	-5,198	-2,786	-3,135	-3,113
Of which: Oil sector investment 1/	-216	-444	-602	-492	-528	-568
Services and transfers	-1,093	-1,310	-1,175	-710	-1,029	-1,075
Of which: Interest payments	-900	-968	-1,063	-1,134	-1,252	-1,312
Capital account	**84**	**818**	**1,401**	**-1,800**	**-311**	**-140**
Net public sector capital 2/	282	375	431	210	-196	-65
Direct investment 3/	491	696	831	636	685	735
Of which: Oil sector	270	555	753	615	660	710
Other net private sector capital 4/	-689	-253	139	-2,647	-801	-810
Purchase of dollars for dollarization		...	...	...	-771	*-856*
Overall balance	**-55**	**105**	**-768**	**-845**	**-862**	**-573**
Financing	**55**	**-105**	**768**	**845**	**862**	**573**
Free disposable NIR (increase -) 5/	-276	-261	395	422	312	395
Net exceptional financing	331	156	373	423	-925	-1,233
Public sector arrears (decrease -) 6/	231	68	174	331	-925	-1,233
Rescheduling 7/	100	87	199	92	0	0
Financing gap	**0**	**0**	**0**	**0**	**1,476**	**1,412**
(In percent of GDP, unless otherwise specified)						
Current account	**-0.7**	**-3.6**	**-11.0**	**6.9**	**2.0**	**3.2**
Non-oil current account	-9.4	-9.6	-14.3	-2.4	-12.8	-9.6
Trade balance	5.0	3.0	-5.0	12.1	11.4	11.4
Exports	25.6	26.6	21.3	32.3	40.1	35.2
Imports	20.6	23.6	26.3	20.2	28.7	23.7
External debt	**76.2**	**76.9**	**82.2**	**118.8**	**169.9**	**135.4**
Of which: Public sector	65.9	64.2	66.2	100.3	135.6	111.4
To commercial banks	3.1	2.3	2.1	3.4	3.2	2.9
To other creditors	31.4	29.8	31.7	49.5	61.6	50.3
Total external debt service ratio 8/	**28.8**	**30.5**	**35.7**	**33.8**	**41.3**	**40.3**
Of which: Public sector debt	25.4	26.8	30.1	27.7	33.5	32.0
Financing gap	**0.0**	**0.0**	**0.0**	**0.0**	**13.5**	**10.5**
(In percent change)						
Exports, f.o.b.	11.1	7.4	-20.2	5.9	5.3	3.6
Petroleum	13.8	-12.3	-40.7	60.3	37.5	35.3
Non-oil	9.6	18.6	-11.5	-9.4	-10.3	-12.2
Import, f.o.b.	-2.7	18.2	11.4	-46.4	20.7	11.7
Memorandum items:						
Net international reserves 9/	4.9	4.6	3.3	4.2	2.8	2.6
(in millions of US dollars) 10/	1,832	2,093	1,698	1,276	964	881
Excess free disposable net international reserves (increase -) 11/					-459	*-459*
Total external debt (end of period)	**14,589**	**15,198**	**16,221**	**16,353**	**18,589**	**17,750**
Crude oil export prices (in U.S. dollars per barrel)	18.0	15.0	9.2	15.1	19.8	22.0
LIBOR interest rate (percent)	5.59	5.86	5.55	5.50	6.25	6.94

Sources: Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Imports of goods related to new foreign oil sector investments.
2/ Net public sector capital does not include disbursements to the public sector related to the financing gap, except IDB disbursements in April, whereas it includes amortizations related to it.
3/ Excludes possible further privatization proceeds.
4/ Includes errors and omissions.
5/ Free disposable net international reserves from 2000.
6/ Includes clearance of external credit lines in arrears of AGD-intervened banks in 1999 and 2000.
7/ Recapitalization of past due interest (PDI) bonds interest payments in 1995-1999; in 1998, also includes rescheduled amortization due to FLAR (Fondo Latinoamericano de Reservas); in 1999, also includes capital gains on buyback of Brady bonds.
8/ As percentage of exports of goods and nonfactor services.
9/ In months of imports of goods and nonfactor services.
10/ In 2000 NIR accumulation is offset by the cost of dollarization
11/ Refers to free disposable net international reserves covering the operations system of the central bank balance sheet.

Table 9. Ecuador: External Financing Requirements 1998-2000

(In millions of U.S. dollars)

			Program 2000				Total
	1998	1999	Q1 1/	Q2 1/	Q3	Q4	2000
Requirements	**2,690**	**2,267**	**690**	**582**	**269**	**469**	**2,010**
Current account deficit	2,170	-955	-414	-426	45	372	-423
Of which : Interest payments	1,063	1,133	293	255	389	376	1,312
Capital outflows	521	3,222	1,104	1,008	224	97	2,432
Scheduled public sector amortization	660	595	178	165	190	232	766
Multilateral loans 2/	322	287	120	77	127	101	425
Bilateral loans	209	176	49	65	32	74	220
Bank loans	76	64	0	8	22	41	71
Bonds and notes	26	47	0	10	0	10	19
Suppliers credits	26	21	9	6	9	7	31
Private sector flows net (+ outflows)	-139	2,628	440	570	-33	-168	810
External credit lines (including offshore lines	...	1,096	100	150	30	0	280
Other net private credit 3/	...	1,531	340	420	-63	-168	530
Foreign exchange cost of dollarization	...	...	485	273	66	32	856
Resources	**2,690**	**2,269**	**690**	**583**	**-732**	**544**	**1,085**
Capital inflows	1,922	1,424	356	361	358	361	1,436
Foreign direct investment	831	636	200	170	182	183	735
Disbursements to public sector	1,091	788	156	191	176	178	701
Multilateral loans 4/	860	468	41	141	99	106	386
Bilateral loans	166	191	28	38	14	40	120
Bank loans	36	11	42	7	11	17	77
Bonds and notes	0	0	0	0	0	0	0
Suppliers credits	29	118	0	5	5	15	25
Other 5/			45	0	48	0	93
Additional financing	199	92	0	119	172	196	487
Emergency program financing	...	0	0	119	172	196	487
World Bank	...	0	0	0	72	30	102
Inter-American Development Bank	...	0	0	79	60	126	265
Andean Investment Corporation (CAF)	...	0	0	40	40	40	120
Other 6/	199	92	0	0	0	0	0
Change in arrears (- decrease) 7/	174	331	241	98	-1,573	0	-1,233
Change in free disposable NIR 8/	395	422	93	4	311	-13	395
Change in excess free disposable NIR 9/			-479	69	29	-78	-459
Residual financing gap	**0**	**0**	**0**	**0**	**1,001**	**-75**	**925**

Sources: Central Bank of Ecuador, and Fund staff estimates.

1/ First quarter actual; second quarter estimated.
2/ Excludes IMF repurchases untill 1999.
3/ Includes errors and omissions.
4/ Project loan disbursments; in 1998 it also includes disbursements of program loans.
5/ Includes capitalization of interest on PDI bonds
6/ In 1998, includes rescheduling of amortization due to FLAR and in Q1/1999 capital gains on buyback of Brady bonds.
7/ Includes arrears on external credit lines of AGD-intervened banks of US$63 million, refinanced in Q4 1999, and US$69 million of new arreas in 2000.
8/ Includes IMF repurchases until 1999; "-" is increase.
9/ Refers only to free disposable net international reserves to cover the operations system of the central bank balance sheet.

Table 10. Ecuador: Public Sector External Arrears, 1998-2000

(In millions of U.S. dollars; at end of period)

	1988	1999	May 2000
Multilateral debt (technical arrears)		**19**	**21**
World Bank		12	10
Inter-American Development Bank (IDB)		7	11
Bilateral debt	**542**	**694**	**742**
Paris Club creditors	542	692	741
Pre-cutoff date debt	524	650	692
Post-cutoff date debt	12	42	49
Non-Paris Club creditors (post cutoff date debt)	0	1	1
Commercial debt	**2**	**149**	**314**
Brady bonds	0	91	225
Interest equalization (IE) bonds		14	14
Discount bonds		45	92
Par bonds		33	67
PDI bonds		0	51
Eurobonds	0	28	56
Commercial bank loans	1	26	31
Suppliers credits	0	2	2
Other	1	1	1
Trade credit lines of intervened banks 1/	**...**	**63**	**154**
Total	**544**	**924**	**1,231**

Sources: Central Bank of Ecuador; and Fund staff estimates.

1/ Includes the external credit lines of intervened banks.

Table 11. Ecuador: External Debt 1996-2000

	1996	1997	1998	1999	Proj. 1/ 2000
(In millions of U.S. dollars end of period)					
Total debt	**14,589**	**15,198**	**16,221**	**16,353**	**17,750**
External debt of Ecuadoran private sector	1,958	2,520	3,159	2,539	3,139
External debt of Ecuadoran public sector	12,631	12,678	13,061	13,814	14,611
Multilaterals	3,564	3,479	3,905	4,025	4,571
IMF	145	134	69	0	268
World Bank	1,011	876	878	888	919
IDB	1,743	1,708	1,844	1,878	2,061
CAF	540	688	795	840	1,038
Others	125	73	319	419	304
Bilaterals	2,345	2,353	2,282	2,617	1,864
Previously rescheduled debt	1,128	1,177	1,237	1,191	453
Pre-cutoff debt	87	68	61	55	48
Post-cut debt	1,130	1,109	985	1,371	1,363
Commercial banks	603	447	423	474	384
Previously rescheduled debt	75	73	71	88	88
Other	528	374	352	385	296
Euro and Brady bonds	6,013	6,334	6,383	6,531	6,707
Suppliers	106	65	68	167	159
Other (gap financing)					925
(In percent of GDP)					
Total debt	**76.2**	**76.9**	**82.2**	**118.8**	**135.4**
External debt of Ecuadoran private sector	10.2	12.8	16.0	18.4	23.9
External debt of Ecuadoran public sector	65.9	64.2	66.2	100.3	111.4
Multilaterals	18.6	17.6	19.8	29.2	34.9
Bilaterals	12.2	11.9	11.6	19.0	14.2
Commercial banks	3.1	2.3	2.1	3.4	2.9
Euro and Brady bonds	31.4	32.1	32.3	47.4	51.1
Suppliers	0.6	0.3	0.3	1.2	1.2
Other (gap financing)					7.1
(Shares in percent of total)					
Total debt	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
External debt of Ecuadoran private sector	13.4	16.6	19.5	15.5	17.7
External debt of Ecuadoran public sector	86.6	83.4	80.5	84.5	82.3
Multilaterals	24.4	22.9	24.1	24.6	25.8
Bilaterals	16.1	15.5	14.1	16.0	10.5
Commercial banks	4.1	2.9	2.6	2.9	2.2
Euro and Brady bonds	41.2	41.7	39.4	39.9	37.8
Suppliers	0.7	0.4	0.4	1.0	0.9
Other (gap financing)					5.2

Source: Central Bank of Ecuador, and Fund staff estimates.

1/ The totals do not incorporate the debt reduction that would result from a successful exchange of Bradybonds and Eurobonds because the precise amount is not known at this time.

Table 12. Ecuador: Projected Payments to the Fund as of July 31, 2000

(In millions of SDRs)

	2000	2001	2002	2003	2004	2005	2006	Total
Obligations from existing drawings								
1. Principal								
a. Repurchases	0	0	0	21.3	42.5	21.3	0	85.1
b. PRGF/SAF repayments	0	0	0	0	0	0	0	0
2. Charges and interest 1/								
a. on Fund credit	2.3	4.7	4.7	4.5	2.6	0.4	0	19.2
b. on use of SDRs	0.7	1.4	1.5	1.5	1.5	1.4	1.5	9.5
Total obligations 2/	3	6.1	6.1	27.2	46.5	23.1	1.5	113.5
(percent of quota)	1.0	2.0	2.0	9.0	15.4	7.6	0.5	37.5
Obligations from prospective drawings								
1. Principal								
a. Repurchases	0	0	0	3.5	66.1	67.3	4.7	141.6
b. PRGF/SAF repayments	0	0	0	0	0	0	0	0
2. Charges and interest 1/								
a. on Fund credit	0.9	7.1	7.8	7.8	6.4	2.6	0.1	32.7
b. on use of SDRs	0	0	0	0	0	0	0	0
Total obligations 2/	0.9	7.1	7.8	11.3	72.6	70	4.8	174.5
(percent of quota)	0.3	2.4	2.6	3.8	24.0	23.1	1.6	57.8
Cumulative (existing and prospective)								
1. Principal								
a. Repurchases	0	0	0	24.8	108.6	88.6	4.7	226.7
b. PRGF/SAF repayments	0	0	0	0	0	0	0	0
2. Charges and interest 1/								
a. on Fund credit	3.3	11.8	12.5	12.3	9	3	0.1	52
b. on use of SDRs	0.7	1.4	1.5	1.5	1.5	1.4	1.5	9.5
Total obligations 2/	4	13.3	13.9	38.5	119.1	93.1	6.3	288.2
(percent of quota)	1.3	4.4	4.6	12.7	39.4	30.8	2.1	95.3

Source: IMF staff.

1/ Projections are based on current rates of charge, including burden-sharing charges where applicable, for purchases in the GRA, and on current interest rates for SAF, PRGF, and Trust Fund. The current SDR interest rate is assumed for net use of SDRs.

2/ Overdue obligations (if applicable) will be settled in full at close of business August 1, 2000.

ECUADOR: STATUS OF THE FINANCIAL SECTOR REFORMS. FIRST REVIEW[1]

Action	Date due	Implementation status
II.a. Approve remaining amendments to the financial institutions law: (i) Allowing banks falling below minimum regulatory CAR to operate under private control and ownership by removing the requirement to transfer shares to a "fideicomiso"; and (ii) not interfering with the basis for a corporate debt restructure scheme according to the principles included in action IV.b below.	March 2000	(i) A draft amendment law to the financial institutions law has been included in the *Ley Trole II*; (ii) Banking board resolutions have been approved, establishing an adequate regulatory framework for a voluntary debt restructure scheme.
III.a. Approval of revised requirements for loan classification, loss provisioning, and interest suspension to conform with best international practices.	Approval by March 2000 Implementation by June 2000 (performance criterion)	Resolution on new requirements passed by banking board
III.b. Revise loan classification and loss provision requirements of restructured loans so that a restructured loan cannot be reclassified to a better credit risk category prior to establishing a track record of at least three payments or six months.	Approval by March 2000 Implementation by June 30, 2000 (performance criterion)	Resolution on new requirements passed by banking board
III.e Introduce and regulate a system of prompt corrective action when banks fall below their regulatory minimum CAR , including mandatory intervention (and removal of shareholders' voting rights) in cases where a bank's CAR falls below 1.8 percent or it fails to meet its recapitalization plans. In these cases, banks would be wound up or would continue operating after being recapitalized by (and ownership transferred to) the AGD, according to least cost criteria.	June 30, 2000	A draft resolution is being prepared with the assistance of a World Bank consultant.
III.f For banks falling below the regulatory minimum CAR of 9 percent (but remaining above 1.8 percent), establish time-bound and contractually binding memoranda of understandings (MOUs) based on uniform criteria for their strengthening, which will be reviewed at least every six months. Such plans must include bringing in new capital and a business plan for strengthening management, restoring profitability through cutting operating costs and other means, and improving the recovery of weak assets.	General framework established by June 2000 (performance criterion)	A draft resolution prepared with the assistance of a World Bank consultant has been submitted for comments to Fund's staff and other IFIs; some modifications will be required.
III.g. Recapitalization should maximize reliance on private resources. The government will introduce a scheme for providing public capital proportionally to private capital contributions under uniform and strictly defined rules.	June 30, 2000	A draft resolution prepared with the assistance of a World Bank consultant has been submitted for comments to Fund's staff and other IFIs; some modifications will be required.

[1] Status of actions due and past due for the first program review. Numbering of items refers to the financial sector matrix contained in the staff report accompanying the original Stand-By request (EBS/00/66)

Action	Date due	Implementation status
IV.b. Announce a debt restructuring framework for case-by-case restructuring of debts above US$50,000, based on the principles of voluntary participation of creditors and debtors acceptable to IFIs. Only debt of viable enterprises will be restructured; no support or subsidies by the public sector or IFIs.	April 2000	Two banking board resolutions have been approved, establishing an adequate regulatory framework for a voluntary debt restructure scheme.
IV.c. Identify structural obstacles to corporate workouts and remove those which could be eliminated by administrative action.	May 2000	Two reports identifying obstacles to workouts, including necessary reforms to the bankruptcy legislation and judicial and administrative procedures have been prepared by MAE and a local lawyer. A summary of the findings has been submitted to the IFIs, pending assessment.
IV.d. Undertake an assessment of the adequacy of existing bankruptcy legislation and legislation related to the mobilization of loan collateral and debt recovery.	May 31, 2000	
IV.e. Assess adequacy of judicial and administrative procedures for bankruptcy, debt recovery, and foreclosure of property.	May 31, 2000	
VI.a. Develop instruments for liquidity recycling by the central bank (through its third balance sheet)	April 2000	Established.
VI.b. Start issuing short-term central bank (U.S. dollar-denominated) bonds in daily auctions.	April 2000	The central bank has started to issue U.S. dollar-denominated bonds, but in only small amounts and infrequently.
VI.c. Design repo facility in such a way that illiquid banks have access to it.	April 2000	The superintendency will certify access to the central bank facility for banks below 9 percent CAR in compliance with a recapitalization plan approved by the superintendency.
VI.e. Negotiate fast disbursing funds for the liquidity support facility.	April 2000	The CAF has approved using up to US$70 million of its US$200 million loan for funding the liquidity fund. Disbursement of the first US$40 million is expected shortly.
VI.f. Secure commitments with foreign banks to stabilize and reconstitute their interbank and trade-related credit lines to open AGD banks with the technical support of the IFIs during the negotiations.	May 2000	The authorities are engaged in negotiations with the banking syndicate lead by Barclays Bank to refinance the lines of closed AGD banks, including those of Banco de Préstamos and Banco Popular. The arrangements would include provisions to remove the burden on Filanbanco's trade lines, but the discussions have not been completed.
VII.a. Develop regulations for the resolution of closed banks. Shareholders will lose their investment and voting rights and managers will be legally accountable. Deposit guarantees will be paid out as soon as possible within the constraints of the dollarization scheme and fiscal sustainability.	April 2000	A draft resolution to regulate the resolution of closed banks is being prepared with the assistance of a World Bank consultant.
VII.b. Establish a time-bound program for the disposal of assets acquired by the AGD in the resolution process, which will include an asset management strategy covering institutional arrangements, information and transparency, and private sector outsourcing.	March 2000	A draft plan has been produced with the help of a World Bank consultant, and is pending approval from the AGD board. The draft needs to be strengthened in three areas: (1) quantitative objectives; (2) immediate asset management measures; and (3) use of coactiva powers and analysis of incidence of the latest changes in the regulatory framework.
VII.c. AGD will start the disposal of assets of closed banks and will announce a timetable for the liquidation of remaining AGD assets.	May 2000	A substantial amount of Banco Popular's assets and liabilities were successfully auctioned in April. A preliminary timetable for the liquidation of remaining assets is included in the plan mentioned in VII.b, but needs further streamlining.

Action	Date due	Implementation status
VIII.b Issue regulations regarding gradual elimination of off-shore banking operations conducted within the country and in countries which do not meet international supervisory standards.	June 2000	No progress has been reported.
IX.a. Prepare a strengthening plan for the Superintendency of Banks that should include the following actions: (i) Improve on-site supervision through a practical training program, which will support the special loan portfolio assessments mentioned in III.d. (ii) Reorganization of the structure of the Superintendency of Banks to ensure adequate regional and interdepartmental coordination, including a proposal to rationalize human resources. (iii) Improvement of off-site supervision, including system developments that will ensure monitoring, analysis, and eventual identification of "at risk" banks (based on a system of stress testing).	June 2000. Implementation will begin by September 2000	A satisfactory strengthening plan was prepared with the assistance from of MAE consultant and was approved by the banking board.
IX.c. Initiate bilateral agreements with relevant foreign supervisors to share supervisory information.	April 2000	Agreements with Superintendencies of Colombia, Perú, and Venezuela were already in place by 1999. Proposals for bilateral agreements have been submitted to several other countries.
IX.b. Introduce a ladder of intensified supervisory action for noncompliance with regulatory norms.	April 2000	Instructions to check compliance during on-site inspections have been given. A definition of noncompliance categories and corresponding ladder of intensified supervisory action has not been prepared yet.
IX.e. The Superintendency of banks will enforce existing regulations and will apply penalties and disciplinary measures on a uniform and nondiscretional basis. It will enforce reporting requirements and require access to any other information that it deems relevant, especially for offshore banks. The authorities will review the level and uniformity of penalties.	April 2000	A second draft regulation has been prepared with the help of MAE and submitted to the IFIs for comments.
IX.g. Enforce existing limits on connected lending, loan concentration, and investment in fixed assets, in part by introducing appropriate penalties for banks, management, and board members.	April 2000	Two banking board regulations on internal control procedures and fit and proper requirements have been approved. No progress reported on the establishment of the public registry.
IX.f. Strictly apply Basle fit and proper criteria to owners and managers of all banks and develop a public registry for management, directors, and principal owners.	April 2000	See immediately above.
X.b. Evaluate and develop a national program for strengthening corporate governance, including strengthened awareness of the responsibilities of owners, directors, external and internal auditors, audit committees, and the protection of minority shareholders.	June 2000	Preliminary draft programs are being prepared with the assistance of MAE and the World Bank.
X.c. Undertake independent financial and management audits of all special-purpose public banks, including the CBE, to provide the informational basis for a reform program to substitute first-tier operations with more effective mechanisms and to consolidate second-tier operations in one institution.	Initiated by June 30, 2000 and completed by December 30, 2000	The central bank is leading a working group drafting the TOR for the audits.

Medium-Term External and Fiscal Sustainability

This appendix provides an updated analysis of Ecuador's medium-term external and fiscal sustainability and how this is affected by the debt exchange offer launched on July 27, 2000. This analysis starts from a baseline projection of the external and fiscal financing gaps in the absence of any debt relief or rescheduling from official creditors. Any assessment of medium-term sustainability undertaken in the midst of an economic crisis will inevitably be subject to considerable uncertainty. Nevertheless, this analysis suggests that a successful debt exchange on the terms included in the exchange offer, combined with Paris Club rescheduling of bilateral debt on terms as assumed in the program, would substantially improve Ecuador's medium-term sustainability, provided a substantial fiscal effort is maintained.

I. A Medium-Term Baseline Scenario Without Debt Relief

The macroeconomic framework assumes that economic growth will, after an initial "catch-up" effect in 2001 as the crisis abates, gradually increase to 4 percent in 2011 (Table 1). The inflation rate is projected to decline fairly rapidly, and to approach U.S. levels after a period of four-five years.

The balance of payment projections are based on: (i) WEO assumptions on developments in export prices, including oil prices (which are projected to decline from their current level to a medium-term average of US$19 per barrel); (ii) an average elasticity of imports with respect to GDP of 1.5; (iii) a gradual reversal of private capital outflows as confidence returns, with modest net inflows starting in 2004; and (iv) an average annual accumulation of free disposable international reserves (starting in 2001) of US$260 million a year to build up a prudential liquidity reserve.

On the fiscal side, it is assumed that there will be a sustained adjustment effort sufficient to keep a primary surplus of about 6 percent of GDP until 2007.[1] After this, the primary surplus is projected to decline gradually to 3.5 percent of GDP to make room for increased investment spending on infrastructure and poverty alleviation measures. For the purpose of estimating the fiscal financing gaps, it is conservatively assumed that the public sector will not issue any new domestic debt to finance its operations.

This scenario suggests that the debt service burden would impose a significant medium-term sustainability problem for Ecuador. The external financing gaps would, after reaching about US$1.4 billion in 2000, decline to an annual average of US$345 million over the next five

[1] In light of the different real exchange rate this implies a slightly different path in U.S. dollar terms of the primary surplus (higher initially and slightly lower in the out-years) than assumed in the projection prepared at the time of the Stand-By approval (see Appendix I of EBS/00/66).

years (equivalent to 1.6 percent of GDP on average), and then to an annual average of about US$170 million over the following 10 years (equivalent of 0.4 percent of GDP on average). The ratio of external debt to GDP, the bulk of which is public sector debt, would decline from 135 percent this year to about 50 percent at the end of the simulation period. However, much of this decline would come in 2000–04 as a result of the projected appreciation of the real exchange rate. Similarly, external debt service would decline from its current level of about 40 percent of exports of goods and non-factor services to about 20 percent by 2015. On the fiscal side, the financing gaps in 2001–05 would run somewhat higher because of maturing domestic debt, at about 3.5 percent of GDP a year, then decline to an average of 0.6 percent of GDP a year over the following ten years. Total debt service from the public sector would amount to 15.9 percent of GDP in 2000, declining only to 12.6 percent in 2005 and to 5.8 percent in 2015.

This scenario is highly sensitive to some of the key assumptions. A sustained annual decline in the oil price of US$1 per barrel below the baseline would result in a substantial deterioration in the medium-term outlook. The external trade surplus each year would be significantly reduced, thus directly increasing the annual balance of payments financing gap. The external financing gap would increase by slightly over US$100 million a year on average through 2005, and be about US$500 million higher than the baseline in 2015, reflecting both lower oil export receipts and increased debt service on the higher gaps in the earlier years.

An increase in interest rates by 100 basis points on all debt instruments, except those with a fixed coupon, would have a similar impact.[2] The external current account balance would deteriorate by about US$100 million over the first five–six years, and by almost US$600 million by 2015.

II. The Exchange Offer

The exchange offer was launched on July 27, 2000, and the key features on the new "global bonds" and the exchange factors are discussed in Box 2 above. The exchange ratios for each type of Brady bond and Eurobond after the payout of the principal collateral have been set by the authorities in manner that is linked to the historical stripped secondary market relative prices of the different types of bonds. This puts the value of the Eurobond at face value,[3] but provides for significant discounts on the Brady bonds (the exception is the interest equalization bond, which will be exchanged at par). Other key elements of the exchange offer are:

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[2] Of current (pre-debt exchange offer) external debt, all private sector debt and almost all public sector debt has a floating interest rate (the exceptions on public debt being part of debt to multilaterals, the Par bonds, and one of the Eurobonds).

[3] Excluding the impact of the additional 35 percent debt reduction for those who accept the 12-year bond. The overall net present value debt-service reduction on the bonds is more substantial, because of the conversion into an instrument of much longer maturity at lower interest rates.

- The government is required to retire a certain proportion of the bonds outstanding each year (US$125 million a year beginning in year 6 for the 12-year bond, and 3 percent of the total outstanding a year beginning in year 13 for the 30-year bond) through either purchases in the secondary market, or other initiatives such as debt-equity swaps for privatization initiative (legislation is to be introduced to congress shortly to allow the use of debt swaps as part of a privatization initiative). The targeted retirement schedules are cumulative minimums rather than fixed amortization schedules; the authorities will have the right to enter the secondary market for the bonds at their discretion to take advantage of periods when the bonds are trading at a discount. The remaining principal of both the 12-year and 30-year bonds will be amortized through a final bullet payment at maturity, on the assumption that, by that point, normal market access will have been restored allowing the bullet payment to be refinanced.

- Existing arrears will be cleared in cash and through the release of the interest collateral (of US$186 million). The first coupon payments on the new bonds will not be due until the first half of 2001. Therefore, total cash payments to bondholders are estimated at US$140 million in 2000.

- The new global bonds contain a provision ("a principal reinstatement feature") that, in the event that the government were to default on the new bonds within the next 10 years, bondholders' claims would be adjusted upwards so as to approximately reverse the impact of the debt reduction being granted in the exchange. The aim of this feature is to act as a disincentive for further defaults and, should a default occur in any event, to provide for bondholders' earlier provision of debt reduction to be taken into account in any future negotiation.

- The minimum take-up for the exchange offer to be effective will be 85 percent.[4]

III. A Medium-Term Scenario After Debt Relief

The impact of the exchange offer on debt servicing obligations is illustrated in Table 2. This analysis is based on two key assumptions: (i) there will be a 100 percent take-up on the offer, including a full take-up on the 12-year bond;[5] and (ii) the required "buybacks" before final maturity on the 12-year and 30-year bonds take place at full face value. The latter is a fairly conservative assumption in terms of the medium-term sustainability impact of the exchange offer, since the cash flow payments would be reduced to the extent that the authorities will be able to avail themselves of any secondary market discounts. If the debt were trading at full

[4] An update on bondholders' response to the exchange offer will be provided in a staff supplement prior to the Executive Board meeting.

[5] In practice, the take-up will probably be less than 100 percent; however, it is not yet possible to make any assumptions on how claims on any holdouts will be serviced.

face value, the government would presumably have no difficulty in obtaining further market financing.

On these assumptions, the offer would imply the following:

- The face value reduction in the stock of debt to bondholders would be about 41 percent.
- The external financing gap in 2000 would be eliminated, provided that the Paris Club agrees to a rescheduling in line with program assumptions.
- The staff's latest medium-term projections suggest that the exchange offer would make a sizable contribution to close the projected financing gaps over the medium term.[6] Further assistance from official creditors will likely be needed during 2001–03 but beyond that the remaining external financing gaps should be manageable, especially if the bond buybacks scheduled to begin in 2006 take the form of debt-equity swaps rather than cash payments.
- After the exchange, debt service in relation to exports of goods and nonfactor services would fall sharply; by about 8–10 percentage points a year during 2001–11.
- The fiscal financing gap in 2000 would be largely eliminated, but there would still be a fiscal financing gap, especially over the next three years and in 2005 (when US$765 million of AGD bonds matures), stemming mainly from principal payments on maturing domestic debt. Unless the public sector has regained sufficient access to domestic capital markets to roll over these principal payments, this would require an additional domestic debt restructuring.
- An oil price that deviated from the central WEO projection would obviously impact on this assessment. The exchange offer outlined above (combined with the expected Paris Club rescheduling) would not be sufficient to recover a sustainable position over the medium term if oil prices were, on average, US$1 a barrel lower than assumed above. Similarly, a higher oil price than assumed here, combined with the debt relief, would largely eliminate the remaining financing gaps.
- The exchange offer significantly reduces the sensitivity of the external position to interest rate fluctuations, since the global bonds carry a fixed coupon.

[6] The medium-term projections allow for a significant build-up in official reserves at the central bank in order to provide a liquidity cushion in the event of future pressures on the banking system. Specifically, the ratio of "excess" reserves to M2 rises from 5.7 percent in 2000 to 20.6 percent in 2006, and further to 25 percent in 2015.

Table 1. Ecuador: Key Macroeconomic Parameters

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
GDP (in millions of (U.S. dollars)	13,190	17,747	20,919	23,587	25,509	26,879	28,322	29,842	31,597	33,455	35,423	37,687	40,096	42,659	45,385	48,286
Real GDP growth	0.5	3.5	2.5	2.5	3.0	3.0	3.0	3.0	3.5	3.5	3.5	4.0	4.0	4.0	4.0	4.0
Average inflation	100.0	30.0	15.0	10.0	5.0	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
NFPS primary balance (in percent of GDP)	5.6	6.0	6.0	6.0	6.0	6.0	6.0	5.5	5.3	5.0	5.0	4.0	4.0	3.5	3.5	3.5

Table 2. Ecuador: Summary Balance of Payments 2000-15

	Prog. 2000																
	Orig.	Rev.	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	(In millions of U.S. dollars)																
Current account	**220**	**423**	**-431**	**-512**	**-587**	**-581**	**-608**	**-523**	**-554**	**-627**	**-702**	**-796**	**-754**	**-841**	**-945**	**-997**	**-1,023**
Trade account	1,249	1,498	1,034	1,220	1,224	1,285	1,311	1,296	1,270	1,216	1,146	1,028	1,049	921	746	534	407
Exports, f.o.b.	4,384	4,611	4,735	5,105	5,540	5,998	6,516	7,034	7,579	8,169	8,835	9,548	10,357	11,337	12,428	13,640	15,176
Of which: Petroleum products	1,873	2,002	1,891	2,033	2,185	2,348	2,515	2,658	2,801	2,943	3,087	3,238	3,387	3,533	3,685	3,843	4,008
Imports (f.o.b.)	-3,135	-3,113	-3,701	-3,885	-4,316	-4,713	-5,204	-5,738	-6,309	-6,953	-7,689	-8,520	-9,308	-10,417	-11,682	-13,106	-14,769
Of which: Oil sector investment 1/	-528	-568	-571	-542	-493	-465	-466	-480	-494	-509	-524	-540	-556	-573	-590	-608	-626
Services and transfers	-1,029	-1,075	-1,464	-1,732	-1,811	-1,866	-1,919	-1,819	-1,823	-1,843	-1,848	-1,825	-1,803	-1,762	-1,692	-1,531	-1,430
Of which: Interest payments	-1,252	-1,312	-1,523	-1,743	-1,778	-1,818	-1,869	-1,871	-1,902	-1,945	-1,976	-2,007	-2,040	-2,056	-2,063	-2,079	-2,092
Capital account	**-311**	**-140**	**361**	**280**	**708**	**537**	**620**	**628**	**689**	**763**	**780**	**867**	**869**	**912**	**912**	**959**	**1,140**
Net public sector capital 2/	-196	-65	-157	-341	95	-125	-92	-113	-78	-51	-54	-42	-59	-38	-64	-46	108
Direct investment 3/	685	735	745	718	670	650	672	694	716	740	764	789	815	842	870	898	928
Of which: Oil sector	660	710	714	677	617	581	582	600	618	636	656	675	695	716	738	760	783
Other net private sector capital 4/	-801	-810	-227	-96	-57	12	41	47	51	74	70	119	113	108	107	106	104
Purchase of dollars for dollarization	-771	*-856*	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Overall balance	**-862**	**-573**	**-69**	**-231**	**121**	**-43**	**12**	**105**	**136**	**136**	**78**	**71**	**114**	**71**	**-33**	**-38**	**117**
Financing	**862**	**573**	**69**	**231**	**-121**	**43**	**-12**	**-105**	**-136**	**-136**	**-78**	**-71**	**-114**	**-71**	**33**	**38**	**-117**
Free disposable NIR (increase -) 11/	312	395	-343	-335	-361	-225	-249	-219	-241	-274	-184	-195	-224	-238	-254	-270	-287
Net exceptional financing	-925	-1,233	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Public sector arrears (decrease -) 5/	-925	-1,233	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Rescheduling 6/	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Financing gap	**1,476**	**1,412**	**412**	**566**	**240**	**269**	**236**	**114**	**105**	**138**	**106**	**124**	**110**	**167**	**287**	**308**	**170**
	(In percent of GDP, unless otherwise specified)																
Current account	**2.0**	**3.2**	**-2.4**	**-2.5**	**-2.5**	**-2.3**	**-2.3**	**-1.9**	**-1.9**	**-2.0**	**-2.1**	**-2.3**	**-2.0**	**-2.1**	**-2.2**	**-2.2**	**-2.1**
Non-oil current account	-12.8	-9.6	-11.3	-10.7	-10.3	-10.0	-10.1	-9.6	-9.5	-9.5	-9.4	-9.4	-8.9	-8.7	-8.5	-8.2	-7.9
Trade balance	11.4	11.4	5.9	5.9	5.2	5.1	4.9	4.6	4.3	3.9	3.5	2.9	2.8	2.3	1.8	1.2	0.9
Exports	40.1	35.2	26.8	24.5	23.6	23.8	24.5	25.1	25.7	26.1	26.7	27.2	27.8	28.6	29.4	30.4	31.8
Imports	28.7	23.7	21.0	18.7	18.4	18.7	19.6	20.5	21.4	22.2	23.2	24.3	25.0	26.3	27.7	29.2	30.9
External debt	**169.9**	**135.4**	**102.4**	**89.0**	**78.4**	**74.0**	**70.7**	**68.3**	**66.3**	**64.3**	**62.0**	**59.9**	**57.3**	**54.9**	**52.7**	**50.2**	**47.6**
Of which: Public sector	135.6	111.4	79.7	69.2	60.6	57.0	54.3	52.0	49.9	48.0	46.0	44.2	42.2	40.5	38.9	37.1	35.2
To commercial banks	3.2	2.9	2.1	1.7	1.4	1.1	1.0	1.4	1.3	1.2	1.3	1.4	1.6	1.8	2.1	2.3	2.5
To other creditors	61.6	50.3	37.8	32.5	29.5	28.0	27.2	26.5	26.0	25.8	25.3	24.9	24.2	23.4	22.5	21.4	20.4
Total external debt service ratio 7/	**41.3**	**40.3**	**42.5**	**46.4**	**37.4**	**41.8**	**38.9**	**35.9**	**33.6**	**33.0**	**31.2**	**29.5**	**29.4**	**27.6**	**25.8**	**23.6**	**20.2**
Of which: Public sector debt	33.5	32.0	34.3	35.9	27.5	32.4	29.7	27.4	25.2	24.8	23.2	21.8	22.1	20.7	19.4	17.6	14.8
Financing gap	**13.5**	**10.5**	**2.3**	**2.7**	**1.0**	**1.1**	**0.9**	**0.4**	**0.4**	**0.4**	**0.3**	**0.4**	**0.3**	**0.4**	**0.7**	**0.7**	**0.4**
	(In percent change)																
Exports, f.o.b.	5.3	3.6	2.7	7.8	8.5	8.3	8.6	8.0	7.7	7.8	8.2	8.1	8.5	9.5	9.6	9.8	11.3
Petroleum	37.5	35.3	-5.6	7.5	7.5	7.5	7.1	5.7	5.4	5.1	4.9	4.9	4.6	4.3	4.3	4.3	4.3
Non-oil	-10.3	-12.2	9.0	9.7	9.4	9.4	8.7	9.0	9.0	9.4	9.5	9.9	10.8	10.9	11.5	12.1	14.0
Import, f.o.b.	20.7	11.7	18.9	5.0	11.1	9.2	10.4	10.2	10.0	10.2	10.6	10.8	9.2	11.9	12.1	12.2	12.7
Memorandum items:																	
Net international reserves 8/	2.8	2.6	3.0	3.6	4.0	4.1	4.2	4.2	4.3	4.3	4.2	4.0	3.9	3.8	3.6	3.5	3.3
(in millions of U.S. dollars) 9/	964	881	1,223	1,558	1,919	2,144	2,393	2,612	2,853	3,127	3,310	3,505	3,729	3,968	4,222	4,492	4,779
Excess free disposable NIR (increase -) 10/	-459	*-459*	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total external debt (end of period)	**18,589**	**17,750**	**18,075**	**18,501**	**18,384**	**18,667**	**18,812**	**19,152**	**19,585**	**20,092**	**20,517**	**20,996**	**21,363**	**21,790**	**22,239**	**22,527**	**22,756**
Crude oil export prices (in U.S. dollars per barrel)	19.8	22.0	18.1	17.3	17.5	17.8	18.2	18.7	19.1	19.4	19.6	19.9	19.9	19.9	19.7	20.2	20.7
LIBOR interest rate (in percent)	6.25	6.94	7.52	7.52	7.52	7.52	7.52	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25	6.25

Sources: Central Bank of Ecuador; and Fund staff estimates and projections.

1/ Imports of goods related to new foreign oil sector investments.
2/ Net public sector capital does not include disbursements to the public sector related to the financing gap, except IDB disbursements in April, whereas it includes amortizations related to it.
3/ Excludes possible further privatization proceeds.
4/ Includes errors and omissions.
5/ Includes clearance of external credit lines in arrears of AGD-intervened banks in 1999 and 2000.
6/ Recapitalization of past due interest (PDI) bonds interest payments in 1995-99; in 1998, also includes rescheduled amortization due to FLAR (Fondo Latinoamericano de Reservas); in 1999, also includes capital gains on buyback of Brady bonds.
7/ As percentage of exports of goods and nonfactor services.
8/ In months of imports of goods and nonfactor services.
9/ In 2000 NIR accumulation is offset by the cost of dollarization
10/ Refers to free disposable net international reserves covering the operations system of the central bank balance sheet.
11/ Free disposable net international reserves from 2000.

Table 3. Ecuador: Nonfinancial Public Sector Financing Before Bond Exchange Operation, 2000-15

	Rev. Prog.	Projections														
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
	(In millions of U.S. dollars)															
Primary balance	**735**	**1,065**	**1,255**	**1,415**	**1,531**	**1,613**	**1,699**	**1,641**	**1,659**	**1,673**	**1,771**	**1,507**	**1,604**	**1,493**	**1,588**	**1,690**
Net domestic requirements	**-632**	**-904**	**-915**	**-1,142**	**-768**	**-1,511**	**-779**	**-812**	**-847**	**-768**	**-728**	**-659**	**-624**	**-606**	**-504**	**-470**
Interest due	-288	-323	-304	-309	-311	-269	-282	-278	-272	-262	-246	-217	-202	-180	-161	-142
Amortization due	-431	-343	-349	-534	-276	-1,024	-312	-328	-341	-365	-333	-270	-239	-231	-136	-108
Domestic bond issues	9															
Restructuring of domestic bonds	224															
Other domestic financing 1/	89															
Change in NFPS deposits (- build up) 2/	-235	-237	-262	-299	-181	-217	-185	-206	-233	-141	-149	-172	-183	-195	-207	-220
Net external requirements	**-998**	**-958**	**-1,419**	**-940**	**-1,109**	**-1,132**	**-1,239**	**-1,188**	**-1,166**	**-1,162**	**-1,139**	**-1,114**	**-1,080**	**-1,092**	**-1,071**	**-1,137**
Interest due	-821	-1,018	-1,044	-1,061	-1,094	-1,094	-1,097	-1,087	-1,081	-1,073	-1,067	-1,063	-1,058	-1,053	-1,057	-1,089
Amortization due	-559	-695	-1,060	-604	-970	-992	-1,054	-1,026	-1,147	-1,173	-1,196	-1,382	-1,440	-1,493	-1,463	-1,443
Net change in arrears	-852															
Capitalization of Brady PDI interest	88															
Project loans disbursement	473	636	685	725	955	955	912	925	1,062	1,084	1,124	1,331	1,418	1,454	1,450	1,395
Emergency program financing	487	120	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Release of Brady Bonds interest collateral	186															
Nonfinancial public sector financing gap	**-894**	**-797**	**-1,079**	**-667**	**-347**	**-1,030**	**-319**	**-358**	**-354**	**-257**	**-96**	**-265**	**-101**	**-205**	**14**	**83**
	(In percent of GDP)															
Primary balance	**5.6**	**6.0**	**6.0**	**6.0**	**6.0**	**6.0**	**6.0**	**5.5**	**5.3**	**5.0**	**5.0**	**4.0**	**4.0**	**3.5**	**3.5**	**3.5**
Net domestic requirements	**-4.8**	**-5.1**	**-4.4**	**-4.8**	**-3.0**	**-5.6**	**-2.8**	**-2.7**	**-2.7**	**-2.3**	**-2.1**	**-1.7**	**-1.6**	**-1.4**	**-1.1**	**-1.0**
Of which : Interest due	-2.2	-1.8	-1.5	-1.3	-1.2	-1.0	-1.0	-0.9	-0.9	-0.8	-0.7	-0.6	-0.5	-0.4	-0.4	-0.3
Of which : Amortization due	-3.3	-1.9	-1.7	-2.3	-1.1	-3.8	-1.1	-1.1	-1.1	-1.1	-0.9	-0.7	-0.6	-0.5	-0.3	-0.2
Of which : Change in deposits	-1.8	-1.3	-1.3	-1.3	-0.7	-0.8	-0.7	-0.7	-0.7	-0.4	-0.4	-0.5	-0.5	-0.5	-0.5	-0.5
Net external requirements	**-7.6**	**-5.4**	**-6.8**	**-4.0**	**-4.3**	**-4.2**	**-4.4**	**-4.0**	**-3.7**	**-3.5**	**-3.2**	**-3.0**	**-2.7**	**-2.6**	**-2.4**	**-2.4**
Of which : Interest due	-6.2	-5.7	-5.0	-4.5	-4.3	-4.1	-3.9	-3.6	-3.4	-3.2	-3.0	-2.8	-2.6	-2.5	-2.3	-2.3
Of which : Amortization due	-4.2	-3.9	-5.1	-2.6	-3.8	-3.7	-3.7	-3.4	-3.6	-3.5	-3.4	-3.7	-3.6	-3.5	-3.2	-3.0
Of which : Project loans disbursement	3.6	3.6	3.3	3.1	3.7	3.6	3.2	3.1	3.4	3.2	3.2	3.5	3.5	3.4	3.2	2.9
Nonfinancial public sector financing gap	**-6.8**	**-4.5**	**-5.2**	**-2.8**	**-1.4**	**-3.8**	**-1.1**	**-1.2**	**-1.1**	**-0.8**	**-0.3**	**-0.7**	**-0.3**	**-0.5**	**0.0**	**0.2**

Sources: Ministry of the Economy and Finance; Central Bank; and Fund staff estimates and projections.

1/ In 2000, it includes private sector financing for Petroecuador (US$111 million), net change in arrears of minus US$11 million, and other operations for US$10 million.

2/ From 2001 onward, it is assumed that the build-up in freely disposable international reserves of the central bank projected in the balance of payments is met by a combination of an increase in bankers deposits at the central bank associated with an increase in M2 and the build-up in deposits shown above.

Table 4. Ecuador: Euro, Brady, and New Global Bonds Debt Servicing

(In millions of U.S. dollars)

	Stock of Debt	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Present estimated debt service on Euro and Brady bonds																	
Total		**565**	**472**	**832**	**440**	**588**	**523**	**512**	**502**	**569**	**552**	**535**	**631**	**605**	**579**	**552**	**552**
Amortization		19	19	382	32	182	141	141	141	225	225	225	348	348	348	348	348
Interest		427	453	450	409	406	382	371	361	344	327	310	283	257	231	204	204
Clearance of arrears		119															
Amortization	6,615																
Interest equalization bonds (IE)	143	19	19	32	32	32											
Discount bonds	1,479																
Par bonds	1,655																
PDI bonds	2,838						141	141	141	225	225	225	348	348	348	348	348
Euro 11.25 percent	350			350													
Euro Floater	150					150											
Interest																	
Interest equalization bonds (IE)		10	9	7	5	2											
Discount bonds		102	112	112	112	112	112	112	112	112	112	112	112	112	112	112	112
Par bonds		66	66	66	66	66	66	66	66	66	66	66	66	66	66	66	66
PDI bonds		106	215	215	215	215	204	193	183	166	149	132	105	79	53	26	26
Euro 11.25 percent		39	39	39													
Euro Floater		16	11	11	11	11											
PDI interest capitalization		88															
Bond exchange 1/																	
Total		**327**	**251**	**276**	**301**	**327**	**352**	**487**	**497**	**482**	**467**	**452**	**437**	**812**	**320**	**313**	**305**
Amortization								125	125	125	125	125	125	500	76	76	76
Interest 2/		327	251	276	301	327	352	362	372	357	342	327	312	312	245	237	229
Of which: Collateral		187															
Of which: New cash		140															
Principal																	
30y global															76	76	76
12y global								125	125	125	125	125	125	500			
Interest																	
30y global			101	126	151	177	202	227	252	252	252	252	252	252	245	237	229
12y global			150	150	150	150	150	135	120	105	90	75	60	60			
Debt service comparison (Present versus bond exchange)																	
Total		**-238**	**-221**	**-556**	**-139**	**-261**	**-171**	**-25**	**-4**	**-86**	**-84**	**-82**	**-194**	**207**	**-258**	**-240**	**-247**
Amortization		-19	-19	-382	-32	-182	-141	-16	-16	-100	-100	-100	-223	152	-272	-272	-272
Interest		-100	-202	-174	-107	-80	-30	-9	12	14	16	18	29	55	14	33	25
Debt service capitalized 3/		-118															
Memorandum items:																	
Debt service reduction (in billions of U.S. dollars)			2.28														
Stock of debt as of Q2 2000 (in billions of U.S. dollars)			6.615														
Stock of arrears as of Dec 1999 (in billions of U.S. dollars)			124.89														
Debt stock reduction 4/ (in percent)			-33.0														
Debt stock reduction 5/ (in percent)			-41.0														

Sources: Central Bank of Ecuador; and Fund staff estimates

1/ 100 percent take up of bond offer

2/ Corresponds to the down payment required to do the bond exchange, including the clearance of arrears accumulated to the closing date.

3/ In the bond exchange operation some US$118 million in debt service that was falling due in 2000 would be converted into new 30-year bonds.

4/ Assumes 100 percent take up of exchange but no takers of 12-year bond

5/ Assumes 100 percent take up of exchange and full take-up of 12-year bond at 0.65:1, max $1.25bn=1.912bn

Table 5. Ecuador: Impact of Bond Exchange on External and Fiscal Financing Gaps

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
(In millions of U.S. dollars)																
Financing gaps before bond exchange operation																
Balance of payment 1/	889	292	566	240	269	236	114	105	138	106	124	95	166	285	307	167
Nonfinancial public sector 2/	894	797	1079	667	347	1030	319	358	354	257	96	265	101	205	-14	-83
Debt service reduction from bond exchange																
Total	-237	-221	-556	-139	-262	-171	-25	-4	-86	-84	-82	-194	207	-258	-239	-247
Amortization	-19	-19	-382	-32	-182	-141	-16	-16	-100	-100	-100	-223	152	-272	-272	-272
Interest	-100	-202	-174	-107	-80	-30	-9	12	14	16	18	29	55	14	33	25
Debt service capitalized	-118															
Financing gaps after bond exchange operation																
Balance of payment	652	71	10	101	7	65	89	101	52	22	42	-99	373	27	68	-80
Nonfinancial public sector 2/	657	576	523	528	85	859	294	354	268	173	14	71	308	-53	-253	-330
(In percent of GDP)																
Financing gaps before bond exchange operation																
Balance of payment 1/	6.7	1.6	2.7	1.0	1.1	0.9	0.4	0.4	0.4	0.3	0.4	0.3	0.4	0.7	0.7	0.3
Nonfinancial public sector 2/	6.8	4.5	5.2	2.8	1.4	3.8	1.1	1.2	1.1	0.8	0.3	0.7	0.3	0.5	0.0	-0.2
Debt service reduction from bond exchange																
Total	-1.8	-1.2	-2.7	-0.6	-1.0	-0.6	-0.1	0.0	-0.3	-0.3	-0.2	-0.5	0.5	-0.6	-0.5	-0.5
Amortization	-0.1	-0.1	-1.8	-0.1	-0.7	-0.5	-0.1	-0.1	-0.3	-0.3	-0.3	-0.6	0.4	-0.6	-0.6	-0.6
Interest	-0.8	-1.1	-0.8	-0.5	-0.3	-0.1	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.1	0.1
Financing gaps before bond exchange operation																
Balance of payment	4.9	0.4	0.0	0.4	0.0	0.2	0.3	0.3	0.2	0.1	0.1	-0.3	0.9	0.1	0.1	-0.2
Nonfinancial public sector 2/	5.0	3.2	2.5	2.2	0.3	3.2	1.0	1.2	0.8	0.5	0.0	0.2	0.8	-0.1	-0.6	-0.7
Total external debt before bond exchange	**137.0**	**102.4**	**89.0**	**78.4**	**74.0**	**70.7**	**68.3**	**66.3**	**64.3**	**62.0**	**59.9**	**57.3**	**54.9**	**52.7**	**50.2**	**47.6**
Of which: Public sector	79.7	69.2	60.6	57.0	54.3	52.0	49.9	48.0	46.0	44.2	42.2	40.5	38.9	37.1	35.2	33.8
Total external debt after bond exchange	**115.7**	**86.8**	**75.7**	**66.7**	**62.7**	**60.2**	**58.2**	**56.6**	**55.1**	**53.3**	**51.7**	**49.6**	**46.9**	**45.2**	**43.1**	**40.6**
Of which: Public sector	58.4	53.6	47.4	45.4	43.0	41.5	39.8	38.2	36.8	35.5	33.9	32.8	30.9	29.6	28.2	26.8
(In percent of exports of GNFS)																
External debt servicing ratios																
Service ratio (excluding bond exchange)	40.3	42.5	46.4	37.4	41.8	38.9	35.9	33.6	33.0	31.2	29.5	29.4	27.6	25.8	23.6	20.2
Of which: Public sector	32.0	34.3	35.9	27.5	32.4	29.7	27.4	25.2	24.8	23.2	21.8	22.1	20.7	19.4	17.6	14.8
Service ratio (including bond exchange)	35.9	38.6	37.3	35.3	38.1	36.7	35.6	33.5	32.1	30.3	28.7	27.8	29.2	24.0	22.0	18.7
Of which: Public sector	27.7	30.4	26.8	25.4	28.8	27.5	27.1	25.2	23.9	22.4	21.0	20.5	22.3	17.6	16.1	13.3

1/ Residual gap after emergency program financing from multilaterals in 2000-01 and the release of interest collateral in 2000.
2/ The difference between the external and fiscal financing gaps largely reflect amortization payments of maturing domestic public debt.

ECUADOR: FUND RELATIONS

(As of July 30, 2000)

I. Membership Status:
Joined: 12/28/45
Status: Article VIII

II. General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	302.30	100.0
Fund holdings of currency	380.15	122.4
Reserve position in Fund	17.15	5.7

III. SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	32.93	100.0
Holdings	0.46	1.4

IV. Outstanding Purchases and Loans:	**SDR Million**	**Percent of Quota**
Stand-By Arrangement	85.00	28.1

V. Financial Arrangements:

Type	**Approval Date**	**Expiration Date**	**Amount Approved (SDR million)**	**Amount Drawn (SDR million)**
Stand-By	4/19/00	4/18/01	226.73	85.00
Stand-By	5/11/94	12/11/95	173.90	98.90
Stand-By	12/11/91	12/10/92	75.00	18.56
Stand-By	9/15/89	2/28/91	109.90	39.25

VI. Projected Obligations to Fund (SDR millions; based on existing use of resources and present holdings of SDRs):

	Overdue	**Forthcoming**				
	6/30/2000	**2000**	**2001**	**2002**	**2003**	**2004**
Principal	0.0	0.0	0.0	0.0	21.3	42.5
Charges/interest	0.0	3.0	5.9	5.9	5.7	3.9
Total	**0.0**	**3.0**	**5.9**	**5.9**	**27.0**	**46.4**

VII. Exchange Rate Arrangement:

In mid-December 1994, the central bank preannounced a nominal exchange rate path, with central bank intervention taking place to keep the *sucre* within a band of initially about 4 percent and a midpoint rate that initially depreciated at an annual rate of 12 percent. The exchange rate path subsequently was modified on several occasions. The last modification was on September 14, 1998, when the exchange rate intervention band against the U.S. dollar was depreciated by 15 percent (in local currency terms) and widened from 5 percent to 7½ percent on each side of the midpoint. On February 12, 1999 the central bank abandoned the exchange rate band and floated the *sucre*. On March 9, 2000 legislation was enacted to dollarize the economy at a conversion rate of 25,000 *sucres* per U.S. dollar.

Ecuador has accepted the obligations of Article VIII, Sections 2, 3, and 4. However, Ecuador maintains an exchange restriction subject to Fund approval under Article VIII, Section 2(a) in the form of the freeze on demand and savings deposits with the banking system.

VIII. Last Article IV Consultation and Recent Contacts:

The 1997 Article IV consultation was concluded by the Executive Board on September 3, 1997 (EBM/97/91). Consultations with Ecuador are on the 12-month cycle.

IX. Technical Assistance:

Dept.	Purpose	Time of Delivery
FAD	Improve tax administration.	March 1993
FAD	Budgeting and planning and fiscal reporting.	April 1993
MAE	Electronic bookkeeping system for central bank debt.	June 1993
MAE and LEG	Review of central bank charter and financial institutions law.	Second and third quarters of 1993
MAE	Payments system and electronic bookkeeping systems for public debt at the central bank.	June 1994
FAD	Improve tax administration.	November 1994–

		July 1997 (on-going)
FAD	Improve monitoring and control system of major public enterprises.	November 1995
MAE	Review new central bank plan of accounts and accounting manual.	October 1995
MAE	Review payments system, operations of current exchange rate system, and prudential regulations for banks.	December 1995
STA	Assist in the design of a producer price index.	February 1997
MAE	Review the central bank's intervention policy and its monetary programming.	January 1998
STA	National accounts statistics.	October 1998
MAE	Assist in the design of a strategy for dealing with banks' systemic problems.	March, May, July, August, December 1999, January 2000
STA	Improvements in banking statistics.	August 1999
FAD	Improvements in social safety net.	June 1999
FAD	Tax reform.	August 1999
STA	Assist in the preparation of the central bank accounts under dollarization.	January 2000

X. Resident Representative:

Mr. Jeffrey Franks; stationed in Quito since September 1999.

ECUADOR: RELATIONS WITH THE WORLD BANK

(In millions of U.S. dollars)

	Commitments	Disbursements	Undisbursed	Repaid	Outstanding
I. IBRD Operations (as of June 30, 2000) 1/					
Total loans	2,304.0	1,967.8	330.1	1,062.7	850.4 2/
Active loans	660.4	330.3	330.1	n.a.	n.a.
Closed loans	1,643.6	1,637.5	0.0	n.a.	n.a.
Active loans (by loan purpose)					
Total	**660.4**	**330.3**	**330.1**		
Adjustment	151.5	0.0	151.5		
Rural development	125.0	84.5	40.5		
Health	135.2	73.0	62.2		
Environment	12.0	6.1	5.9		
Flood control	59.0	57.2	1.8		
Emergency recovery	60.0	51.7	8.3		
Technical assistance	71.7	46.1	25.6		
Other	46.0	11.7	34.3		

II. IFC Operations (as of February 29, 2000)

	Loans	Equity	Participation
Commitments			
Net total held by IFC	47.9	11.6	15.0
Total undisbursed	10.1	1.0	11.2

III. IBRD Loan Transactions (calendar year)
(includes IDA repayments)

	1993	1994	1995	1996	1997	1998	1999	2000
Disbursements	52.1	111.9	319.4	88.7	44.9	84.5	90.3	30.5
Repayments	94.2	95.4	99.2	119.6	102.3	84.4	83.1	41.8
Net lending	-42.1	16.5	220.2	-30.9	-57.4	0.1	7.2	-11.3

IV. World Bank—Policy-Based Lending

The Bank approved a US$152 million Structural Adjustment Loan (SAL) on June 22, 2000. As of July 20, 2000, the loans had not yet been signed. The first tranche of the SAL (US$70 million) would be disbursed upon effectiveness of the loan.

Source: World Bank.

1/ Net of cancellations.

2/ Includes exchange rate adjustments and loans sold to and repaid by third parties.

ECUADOR: RELATIONS WITH THE INTER-AMERICAN DEVELOPMENT BANK

(In millions of U. S. dollars)

	Approved	Disburs-ments	Undis-bursed	Repaid	Out-standing
I. IDB Operations (as of July 31, 2000)					
Total loans	**3,560.3**	**3,020.1**	**540.3**	**1,153.2**	**1,866.9**
Total	**1,275.3**	**753.0**	**522.3**	--	**753.0**
Agriculture and fishery	122.5	78.5	44.0	--	78.5
Tourism	41.0	26.0	15.1	--	26.0
Transportation	221.2	142.9	79.0	--	142.9
Education	67.6	61.9	5.8	--	61.9
Health and Sanitation	210.9	121.3	89.7	--	121.3
Social investment	212.3	48.2	164.2	--	48.2
Rural Development	73.8	68.0	5.8		68.0
Financial Services	210.3	144.2	66.1		144.2
Preinvestment and others	12.0	5.9	6.1	--	5.9
Others	102.9	56.3	46.6		56.3
II. IDB Loan Transactions (as of July 31, 2000)					
	1996	1997	1998	1999	2000 1/
Disbursements	161.1	142.6	186.6	142.0	300.0
Repayments	99.6	94.6	102.8	105.0	125.0
Net lending	61.5	48.0	83.8	37.0	175.0

Source: IDB.

1/ Projected

ECUADOR: WORK PROGRAM

Missions and Board discussions

a.	Board consideration of review and Article IV consultation	August 2000
b.	Second program review mission	September 2000
c.	Board consideration of second review	October 2000
d.	Third program review mission	November 2000
e	Board consideration of third review	December 2000
f.	Fourth program review mission	January 2001
g.	Board consideration of fourth review	February 2001

ECUADOR: STATISTICAL ISSUES

1. Real sector

National accounts (NA) data continue to be compiled following the 1968 SNA guidelines, using an outdated price vector (1975). Timeliness has improved with preliminary quarterly NA being reported with about a three-month lag. Work is underway to adopt the 1993 SNA guidelines for preparation of NA statistics, using 1993 as base year. Technical assistance toward this effort was provided by the Fund during 1998, and the central bank intends to publish the new NA during 2001. Publication of a monthly producer price index (PPI) started in 1999. Adequate labor market data has become available in recent months with the publication of surveys results including employment, unemployment, and participation rates indices, and some private sector wage data. A private university compiles these surveys. Reliable data on public sector employment continues to be unavailable.

2. Government finance

Above the line data for some nonfinancial public sector entities continue to suffer from long reporting lags and unreliable information. In particular, when ownership of public companies was transferred to the social solidarity fund during 1999, financial information on these companies was no longer recorded. Data on domestic bond financing remains unreliable.

3. Monetary accounts

A major effort was undertaken early in 2000 by the central bank, with the support of the Fund, to adapt the presentation of its balance sheet to the requirements imposed by the adoption of the dollarization. This took place at the same time as a major reclassification of accounts was underway to comply with international standards. Banking system data using dollarized accounts became available in the second quarter of the year. Further work is needed to improve the sectorization of financial data; the adoption of new system of accounts by commercial banks, and a strict adherence to the residence principle, are necessary to properly estimate the net external position. In addition, regular surveys should be conducted to estimate the amount of dollar bills and coins in circulation in the economy to improve estimates of monetary aggregates.

4. External sector

Balance of payment statistics are compiled on a quarterly basis by the Central Bank of Ecuador. However, the authorities only report to the Statistics Department annual balance of payments statistics for publication in *International Financial Statistics, IFS* and *Balance of Payments Statistics Yearbook, BOPSY*. The data are still compiled according to the methodology of the *fourth edition of the Balance of Payments Manual (BPM4)*. The balance of payments data are deficient in a number of areas. The reporting of private external debt, private transfers, services, direct investment and portfolio investment should be strengthened.

Ecuador: Core Statistical Indicators
as of July 28, 2000

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/ GNP	External Debt/ Debt Service
Date of Latest Observation	N.A.	7/27/00	7/27/00	7/27/00	7/21/00	7/21/00	6/30/00	5/31/00	3/31/00	5/31/00	6/30/00	5/31/00
Date Received	N.A.	7/28/00	7/28/00	7/28/00	7/28/00	7/28/00	6/30/00	6/20/00	6/20/00	7/20/00	6/20/00	6/20/00
Frequency of Data 1/	N.A.	D	W	D	W	W	M	M	Q	Q	Q	M
Frequency of Reporting 1/	D	D	W	D	W	W	M	M	Q	V	Q	M
Source of Update	A	A	A	A	A	A	A	A	A	A	A	A
Mode of Reporting	E	E	E	E	E	E	E	E	V	V	E	M
Confidentiality 2/	C	C	C	C	C	C	C	C	C	C	C	C
Frequency of Publication	D	D	W	W	W	W	M	M	Q	A	Q	M

1/ D= daily, M= monthly, W= weekly, Q= quarterly.
2/ B= for use by the staff and the Executive Board.

Quito, Ecuador
August 10, 2000

Mr. Horst Köhler
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Köhler:

1. Attached is a supplement to the memorandum of economic policies of the Government of Ecuador for 2000, dated April 4, 2000. It describes recent developments under the economic program, including key policy adjustments to alleviate some of the social costs of the economic crisis, and to keep the program on track. Also attached is a supplement to the technical memorandum of understanding which lists the policy actions to be taken prior to consideration by the Executive Board of the Fund of the first review of the Stand-By Arrangement.

2. As described in the supplement, the review process has been delayed due to ministerial changes in the government. We therefore request that the schedule of purchases under the Stand-By Arrangement be rephased, and that the third purchase, initially scheduled for end-August, be eliminated together with its corresponding review, and that the amount of this purchase be divided equally into the three remaining purchases (which will all remain subject to the completion of a review).

3. The Government of Ecuador request waivers for the non-observance of the performance criteria for central government non-interest payments arrears for end-April, and for the increase in cooking gas prices in July. Furthermore, the Government of Ecuador requests that the end-August indicative target for the floor on the "excess" freely disposable international reserves of the central bank be converted to a performance criterion.

4. The Government of Ecuador reaffirms its commitment to maintain close relations with the Fund and consult on the adoption of policy measures that may be needed during the period of the program.

Sincerely yours,

/s/
Luis G. Iturralde M.
Minister of Economy
and Finance

/s/
José Luis Ycaza
President of the Board of the
Central Bank of Ecuador

Attachments

ECUADOR—SUPPLEMENT TO THE MEMORANDUM OF ECONOMIC POLICIES

I. BACKGROUND

1. The economic program that the administration of President Noboa put in place in March this year, and which is supported by a Stand-By Arrangement from the Fund, has already made good progress in stabilizing financial conditions and laying the basis for economic recovery. This memorandum describes recent developments under the program, including key policy adjustments to alleviate some of the social costs of the economic crisis, adapt to recent developments and keep the program on track. Except as modified in this memorandum, the objectives, policies, targets, and commitments of the economic reform program remain as described in the original memorandum of economic policies dated April 4, 2000.

II. RECENT DEVELOPMENTS

2. **Macroeconomic developments** under the program generally were as expected or better.

- Economic activity in the first half of 2000 appears to have held up better than expected. Real GDP fell by about 1½ percent (year-on-year) in the first quarter; investment fell sharply, but the decline in consumption appears to have bottomed out. Manufacturing sales increased slightly in the first five months of the year; unemployment has declined marginally; and business confidence indicators have improved. However, inflation is running at a much higher rate than projected, as prices have adjusted more rapidly to the earlier depreciation of the *sucre*.

- **The fiscal position is stronger than projected**. The NFPS was broadly in balance in the first four months of the year, against an expected deficit of 2.4 percent of revised GDP in the program. Revenues exceeded program estimates by the equivalent of 1.2 percent of GDP, owing mainly to stronger oil prices (US$23 a barrel in the first half of the year compared to US$20 a barrel assumed in the program) and more buoyant tax revenues. Expenditures were below program by 1.1 of GDP, mainly reflecting shortfalls in investment spending that we expect to be reversed in the second half of the year.

- **The banking system is more liquid than anticipated**. The unfreezing of US$1.2 billion of time deposits in open banks, which began on March 13, proceeded faster than expected as many banks converted to cash the bank bonds that were issued in lieu of frozen deposits. About US$560 million of frozen deposits were paid out in cash in the period March–June, but the deposit base of the banking system increased by about the same amount, suggesting that most of the time deposits unfrozen have remained in the banking system. However, banks' external credit lines fell by a further US$38 million in May (to US$774 million), bringing the cumulative decline this year to about US$200 million; credit to the private sector remains flat; and banks' nonperforming loan ratio reached 47 percent in June.

- **The dollarization of the economy is proceeding rapidly**. Central bank *sucre* liabilities that are legally required to be fully backed by free disposable reserves (FDIR) have fallen sharply, reflecting maturing central bank *sucre*-denominated bonds and a decline in *sucre* currency in circulation. "Excess" FDIR (i.e., above the amount needed for the required backing of *sucre* liabilities and bankers' deposits at the central bank) increased to US$256 million by end-April (adjusted for the accumulation of external arrears and shortfalls in program disbursements), US$90 million above the program target, and further to US$334 million by end-May.

- **Program performance criteria**. The quantitative performance criteria for April were met with the exception of that for domestic non-interest payments arrears. Data on the end-June quantitative performance criteria will be supplied to the Fund prior to consideration of the first review by the Executive Board.

3. **Several policy measures have been implemented**:

- **A package of fiscal revenue and expenditure measures was introduced on May 25**. This included: (i) increases in the prices of diesel and gasoline of 66–92 percent, and in other fuels of between 90–333 percent; (ii) elimination of the import tariff surcharge on electric appliances, parts and accessories, agricultural machinery, and second-hand engines (no reduction was assumed in the program); (iii) increases in public sector pay that averaged about 60 percent (in addition to a 10 percent public sector wage increase granted in April, the program had provided for further increases of 20 percent each in July and October); (iv) an increase in the monthly cash transfer to the poor (the *bono solidario*) of 75 percent (the program had provided for 50 percent); (v) increased spending on rural housing, pensions, child health and education programs, and infrastructure; and (vi) increases in electricity tariffs of up to 50 percent with monthly adjustments thereafter.

- **Steps have been taken to keep the banking strategy on track**. In June, the *Junta Bancaria* approved resolutions that: (i) establish a mainly voluntary scheme to restructure large viable debts to banks of households and corporations, with incentives for creditor and debtor participation; (ii) solve the main problems detected in the creation of the bank liquidity support fund; (iii) establish loan classification and provisioning rules according to international standards; and (iv) strengthen "fit and proper" requirements and internal control procedures of banks. In addition, the *Junta Bancaria* approved a strengthening plan for the superintendency of banks, and rules for access to the central bank's liquidity recycling facility have been clarified to ensure the participation of banks whose capital adequacy ratio falls below the regulatory minimum provided they have an agreed capital strengthening program with the central bank.

- **Discussions with external creditors also have moved forward**, although more slowly than originally hoped. A meeting was held with private creditors on May 16 to discuss Ecuador's adjustment program and medium-term economic prospects to lay the basis for a debt exchange offer in late July. Negotiations to normalize relations with Paris Club creditors were held on May 18–19, and it is the government's intention to conclude the negotiations at a second meeting in early September.

III. THE GOVERNMENT'S MACROECONOMIC PROGRAM FOR 2000

4. The key objectives of the program and broad strategy set out in the original memorandum of economic policies remain unchanged.

5. **The macroeconomic framework of the program** has been revised slightly, as indicated in Box 1 below. The revisions take into account indications that the economic activity appears to be holding up better than expected, inflation will be higher than programmed, and oil exports are likely to perform better than projected, increasing the external current account surplus.

Box 1. Revised Macroeconomic Framework, 2000

	HI	HII	Total
	(Annual percentage change)		
Real GDP			
Revised	-0.7	1.7	½
Original	-3.3 to –2.7	3.5 to 4.0	0 to 1
Consumer price inflation			
Revised: average	92	102	97½
end-of-period	106	87	87
Original: average	76	74	75
end-of-period	71	60	60
	(In millions of U.S. dollars)		
External current account balance			
Revised	830	-417	423
Original	788	-503	220
Change in net free disposable international reserves	410	49	459

IV. Fiscal Policy and Social Safety Net

6. **The combined fiscal deficit target** (in U.S. dollar terms) of the program remains unchanged. However, the composition between the targets for the nonfinancial public sector (NFPS) and the quasi-fiscal balance of the central bank have been revised slightly to take account of a negotiated reduction in the interest rate (from 12 percent to 6 percent) on most of the central bank's portfolio of government bonds (resulting in lower interest payments and a smaller deficit of the NFPS, and a corresponding reduction in the quasi-fiscal surplus of the central bank). In relation to GDP, the targeted fiscal adjustment in 2000 is now larger because nominal GDP for 2000 has been revised upwards mainly to reflect the higher inflation and consequent different real exchange rate path. The combined fiscal deficit would decline from 7.2 percent of GDP in 1999 to 2.7 percent of (revised) GDP in 2000, consistent with a reduction in the NFPS deficit over the period from 6 percent of GDP to 2.8 percent (Box 2). In spite of the increases granted in May, public sector wages would still fall sharply in real terms this year, and by 0.9 percentage points of GDP (to 6.3 percent) from 1999.

Box 2. Revised Fiscal Targets

	(In millions of U.S. dollars)		(In percent of GDP)	
	Revised targets	Original targets	Revised targets 1/	Original targets 2/
Combined fiscal deficit	355	355	2.7	3.2
NFPS deficit	374	430	2.8	3.9
NFPS primary balance	735	723	5.6	6.6
Central bank quasi-fiscal result	19	75	0.1	0.7
Memorandum item:				
Wages and salaries	837	674	6.3	6.2

1/ In percent of revised GDP.
2/ In percent of original GDP.

7. In terms of **expenditure priorities**, the most important objective of the government is to ensure that the adverse impact of the adjustment program on the most vulnerable groups is minimized. Efforts are underway to improve the targeting and efficiency of existing social spending programs, as well as developing approaches to poverty alleviation in the context of a structural adjustment loan from the World Bank. The government intends to maintain spending on social programs this year broadly equal to the level of 1999 in real terms. Priority also is being given to making up the shortfall in the public investment program to provide support for economic activity and poverty alleviation (in particular where projects are labor-intensive and/or provide access to vital services), and ensuring that long-term development objectives are not compromised.

8. For the remainder of this year, **fiscal revenues will be safeguarded** through four measures: (i) there will be no further reductions in import tariffs, including the temporary import tariff surcharge in 2000 unless compensating revenue measures are introduced; (ii) certificates of frozen deposits will remain ineligible for the payment of taxes and import duties; they also will be ineligible for payment in any financial institution, public or private, other than the issuer of the certificate, except at market prices; (iii) electricity tariffs are being moved to levels that will permit the full clearance of arrears to the public sector by electricity distribution companies, and to allow them to remain current on payments to the state-owned generating companies; and (iv) the elimination of the financial transactions tax, which is envisaged in the *Ley para la Promoción de la Inversión y la Participación Ciudadana* (*Ley Trole II*) submitted to congress in mid-July, will be delayed until end-2000 when the associated loss of tax revenue will be compensated by measures to be included in the forthcoming tax reform (see below). The government has already sent a letter to congress proposing this revised timetable.

9. The government brought forward to May many of the increases in fuel prices planned for July and October, and in some cases increased prices of fuels to levels higher than had been envisaged to pay for needed social spending and increases in public sector wages. To alleviate the social impact of the fuel price increases, the government delayed raising the price of cooking gas, which is important in the household budget of the urban poor. The Government of Ecuador requests a waiver for the non-observance of the performance criteria on the increase in cooking gas prices July. The timetable for further increases in domestic fuel prices, and for the increase in cooking gas prices originally programmed for July, will be determined at the time of the second review under the Stand-By Arrangement.

10. The second review under the Stand-By Arrangement also will: (i) set the performance criteria for end-October 2000; and (ii) reconsider the fiscal program to determine how much of any higher than programmed fiscal revenues will go into additional spending on social programs, and how much into deficit and debt reduction, the balance depending in part on the financing assurances for the program. The government will continue to keep fiscal developments under constant surveillance, and will take any additional steps that may be needed, including further increases in domestic fuel prices, to meet the fiscal objectives of the program.

11. In September 2000, the government will submit to the congress a proposal for **a comprehensive tax reform** aimed at increasing revenues from the tax system to help achieve fiscal sustainability while reducing fiscal dependence on oil revenues and distortions from taxation. The main elements of the reform will be as described in the original memorandum of understanding.

V. Monetary Policy and Financial Sector Restructuring

12. The government believes that market imperfections in Ecuador's financial system require the continuation of some form of **usury ceiling on interest rates**, although it recognizes that the ceiling needs to be implemented in a manner that does not interfere with financial intermediation (in particular, that higher risk customers do not lose access to the formal financial markets). To give greater transparency to the setting of the ceiling and to reflect the latest market developments, the government has included in the *Ley Trole II* an amendment to the calculation of the usury rate, setting it at 1.5 times the central bank's active reference rate on new commercial bank loans. The central bank also will apply the usury ceiling in a flexible manner, when needed, to counter stresses in the banking system.

13. To further **safeguard efficient financial intermediation**, the *Junta Bancaria* will reduce the provisioning that commercial banks are required to make on corporate and consumer loans that carry interest rates above 18 percent and 23 percent, respectively.[1] In any event, the special provisioning requirements are set to expire in March 2001. A time table for removing the restrictions on the fees that can be charged by financial institutions in lieu of interest payments will be established at the time of the second review of the program.

14. The government has made substantial progress in implementing policies to support the **strategy to restructure and strengthen the financial system**. A particularly important measure is the scheme approved by the *Junta Bancaria* last June to restructure the large debts of households and corporations. The scheme aims at facilitating economic recovery by easing the liquidity positions of firms and households, while improving banks' asset quality. Incentives to encourage creditor participation include: (i) a flexible classification system for restructured loans is to be applied to loans entering the scheme to encourage banks to recognize implicit losses; and (ii) the failure to restructure a nonperforming loan within the timeframe provided by the scheme will result in the loan being reclassified as a "loss" with a 100 percent provisioning requirement. To encourage debtor participation, debtors who continue in arrears for more than 90 days after the deadline for restructuring would be subject to special foreclosure procedures (the "*coactiva*") To facilitate these procedures, the Executive Board of the Corporación Financiera Nacional (CFN) will approve a resolution establishing a system for applying the "*coactiva*" to the nonperforming credits of private banks. In conjunction with the multilateral institutions, the government is developing mechanisms to monitor closely the implementation of the household and corporate debt restructuring scheme to ensure that it meets its objectives.

15. To provide **incentives for the recapitalization of banks from private sources**, an amendment to the financial institutions law was included in the *Ley Trole II* that will allow

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[1] The scale of provisioning would be reduced to 5 percent of the amount of the loan, and would increase by 2½ percentage points for each 1 percentage point increase in the interest rate.

shareholders to retain ownership and control of a bank if its capital adequacy ratio falls below the regulatory minimum of 9 percent, but remains above 1.8 percent, provided a capital strengthening program had been agreed with the superintendency of banks. The superintendent of banks also will grant access, when needed, to such banks to the central bank's liquidity recycling facility.

VI. Financing of the Program

16. Reassessing the prospects for net external financing (including recent disbursements of program loans from the World Bank and the IDB), the external financing gap for 2000 is estimated at US$1.4 billion (9.8 percent of revised program GDP). The government intends to meet this gap by means of exceptional support from the official international community and an orderly resolution with private external creditors to achieve a more sustainable debt and debt-service position.

17. The authorities have requested a meeting with Paris Club creditors in early September with a view to reaching agreement on the rescheduling of arrears and debt service obligations. The basis for the discussions with creditors will be the assumed financing needs of the government's fiscal program supported by the Stand-By Arrangement with the Fund. In addition, the government intends to go to the market with a debt exchange offer in late July 2000 aimed at normalizing relations with external private creditors. The government will consult with the Paris Club and the Fund in advance of making this offer, with a view to ensuring that the offer is consistent with program financing, and the goal of restoring medium-term fiscal and external sustainability.

18. In June the government entered into negotiations with a foreign bank with a view to normalizing arrears of about US$218 million on external credit lines of intervened banks. In addition, meetings have been arranged with foreign creditor banks in July to seek the maintenance of their exposure under interbank and trade-related credit lines.

VII. Other Structural Policies

19. In the *Ley para la Promoción de la Inversión y la Participación Ciudadana* the government intends to further advance the structural reform process begun in the *Ley de Transformación Económica* approved by the congress last March. The new law will expand the scope of private sector activity, permitting the privatization of public utilities, the state airline TAME, roads, seaports and airports, postal services, and the extraction of nonrenewable natural resources. The regulatory frameworks for the petroleum, mining, electricity, and telecommunications sectors also are to be reformed in order to facilitate privatization and/or joint ventures. Measures also are included to further increase labor market flexibility, including longer probation periods for workers, use of part-time labor, and greater functional mobility for workers within firms.

Table 1. Ecuador: Quantitative Performance Criteria and Indicative Targets for 2000 1/

(In millions of U.S. dollars)

	Prel.	Program			
	Apr.	Jun.	Aug.	Oct. 6/	Dec. 6/
1. Cumulative combined public sector borrowing requirement					
Program	317	323	426	368	355
Actual	-25				
Margin (+ observed)	342				
2. Cumulative nonfinancial public sector borrowing requirement					
Program	310	337	462	424	431
Revised program 2/	310	347	452	407	371
Actual	-11				
Margin (+ observed)	321				
3. Cumulative total central government expenditure					
Program	995	1,417	1,964	2,385	2,857
Revised program 2/	995	1,428	1,955	2,368	2,797
Actual	865				
Margin (+ observed)	130				
4. Cumulative net reduction in central government non-interest domestic arrears					
Program	0	2	3	5	6
Actual	-39				
Margin (- observed)	39				
5. Cumulative disbursements of medium- and long-term external debt to the nonfinancial public sector:					
maturity of over one year					
Program	290	510	610	700	850
Actual	204				
Margin (+ observed)	86				
maturity of one to five years					
Program	40	60	70	90	100
Actual	0				
Margin	40				
6. Stock of net "excess" freely disposable international reserves of the central bank					
Program	187	155	101	154	205
Adjusted program 3/	166				
Actual	256				
Margin (- observed)	-90				
7. Stock of nonfinancial public sector deposits at the central bank 4/					
Program	334	416	411	440	487
Revised program 3/5/	486	589	584	613	660
Actual	671				
Margin (- observed)	-184				

Sources: Central Bank of Ecuador, Ministry of Economy and Finance of Ecuador, and Fund staff estimates.

1/ As defined in the attached Technical Memorandum of Understanding.

2/ The program targets were revised from May onwards to reflect an agreement between the Central Bank and the Ministry of the Economy and Finance to lower the interest and extend the maturities of AGD bonds held by the former.

3/ The program target was adjusted downwards by the shortfall in disbursements in program loans (US$61 million) and adjusted upward by the accumulation of nonrescheduleable arrears (US$39 million).

4/ Indicative target.

5/ The program indicative targets were revised upwards by US$173.4 million at each test date to reflect a change in reporting government deposits at the central bank.

6/ Targets 1-6 are indicative and will be changed to performance criteria during the second review.

ECUADOR—SUPPLEMENT TO THE TECHNICAL MEMORANDUM OF UNDERSTANDING

The following are prior actions for the Fund's Executive Board to consider the first review of the Stand-By Arrangement:

- Congressional approval of the *Ley para la Promoción de la Inversión y la Participación Ciudadana* (*Ley Trole II*) such that: (i) the elimination of the financial transactions tax takes place on January 1, 2001; (ii) the usury interest rate ceiling is set at 1.5 times the central bank's active reference rate on new commercial bank loans; and (iii) shareholders will retain ownership and control of a bank if its capital adequacy ratio falls below the regulatory minimum of 9 percent, but remains above 1.8 percent, provided a capital strengthening program had been agreed with the superintendency of banks.

- Approval by the *Junta Bancaria* of a regulation reducing the provisioning that commercial banks are required to make on corporate and consumer loans that carry interest rates above 18 percent and 23 percent, respectively, according to the schedule set out in Table 1.

- Executive Board of the Corporación Financiera Nacional (CFN) will approve a resolution establishing a system for applying the *"coactiva"* to the nonperforming credits of private banks.

Table 1. Ecuador. Temporary Scale of Provisioning by Banks on Corporate and Consumer Loans 1/

(In percent)

Interest rate	Provisioning requirement	
	Corporate	Consumer
Up to 18	0.0	0.0
Above 18, below 19	5.0	0.0
Above 19, below 20	7.5	0.0
Above 20, below 21	10.0	0.0
Above 21, below 22	12.5	0.0
Above 22, below 23	15.0	5.0
Above 23, below 24	17.5	7.5
Above 24, below 25	20.0	10.0
Above 25, below 26	22.5	12.5
Above 26, below 27	25.0	15.0
Above 27, below 28	27.5	17.5
Above 29, below 30	30.0	20.0
Etc.		

1/ The provision requirement expires on April 1, 2001.